DECLARATORY JUDGMENT IN CERTAIN CASES INVOLVING PUBLIC UTILITIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ADMINISTRATIVE LAW AND GOVERNMENTAL RELATIONS

OF THE

COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

DECLARATORY JUDGMENT IN CERTAIN CASES INVOLVING PUBLIC UTILITIES

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DECLARATORY JUDGMENT IN CERTAIN CASES INVOLVING PUBLIC UTILITIES

THURSDAY, AUGUST 2, 1979

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ADMINISTRATIVE LAW AND
GOVERNMENTAL RELATIONS OF THE
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2226, Rayburn House Office Building, Hon. George E. Danielson (chairman of the subcommittee) presiding.

Present: Representatives Danielson, Barnes, McClory, Kindness, and Moorhead.

Also present: William P. Shattuck, counsel; James H. Lauer, Jr., assistant counsel; Janet Potts, assistant counsel; Alan F. Coffey, Jr., associate counsel; Florence McGrady, clerk.

Mr. DANIELSON. The hour of 10 o'clock having arrived, we will commence hearings on the bill H.R. 229 to amend title 28 of the United States Code in order to provide for declaratory judgment in certain cases involving public utilities. I am glad to see we have a pretty good turnout of people today.

I want the record to reflect that I introduced this bill at the suggestion of representatives of the Pacific Telephone Co. in the 95th and 96th Congresses. The bill addresses what appears to me to be a very important and critical situation in bringing about peace and harmony and good economics in the regulation of utilities and application of laws to them.

So, we have invited a number of interested groups to appear, in fact all of who have an interest and who have something to help us make a decision on the matter. Publicity has been given to the existence of the bill and the proposed hearings and anyone who has some advice to give us on the matter is invited, of course in keeping with the fact we insist on conciseness and brevity and keeping to the point.

[A copy of H.R. 229 follows:]

96TH CONGRESS
1ST SESSION

H. R. 229

To amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 15, 1979

Mr. DANIELSON introduced the following bill; which was referred to the Committee on the Judiciary

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A BILL

To amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 2201 of title 28, United States Code, is amended—

(1) by striking out ", except with respect to Federal taxes,"; and

(2) by adding at the end thereof the following new sentence: "No court may make any such declaration in

a case regarding Federal taxes, except as provided in section 2202.".

SEC. 2. (a) Chapter 151 of title 28, United States Code, is amended by redesignating section 2202 as section 2203 and by inserting immediately after section 2201 the following new section:

"§ 2202. Certain tax controversies

"(a) A court shall issue a declaratory judgment, as provided in section 2201, in a case of actual controversy between a public utility and either the Secretary of the Treasury or a ratemaking body, with respect to the ratemaking or accounting provisions of section 146(f), 167(l), or 167(m) of the Internal Revenue Code of 1954. In any such case the pleading for a declaratory judgment may be filed only by the public utility or by the ratemaking body, as the case may be. In any such case between a public utility and a ratemaking body, the Secretary of the Treasury shall be joined as a party in the action. In any such case between a public utility and the Secretary of the Treasury, the ratemaking body concerned shall be joined as a party in the action.

"(b) No court may issue a declaratory judgment in a case, as provided in subsection (a), unless the court determines that the public utility in the case has obtained a ruling from the Secretary of the Treasury with respect to the controversy, has requested such a ruling and the Secretary of

the Treasury has failed to issue such a ruling within 180 days after the date on which such request was made.

"(c) For purposes of this section, the term 'ratemaking body', when used with respect to a public utility, means a State or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other similar body of any State or political subdivision thereof, which establishes or approves rates chargeable by such public utility.".

(b) The chapter analysis of chapter 151 of title 28, United States Code, is amended by striking out the item relating to section 2202 and by inserting in lieu thereof the following:

"2202. Certain tax controversies.
"2203. Further relief.".

Mr. DANIELSON. We have with us today from the Department of Justice, Hon. M. Carr Ferguson, Assistant Attorney General, Tax Division.

While you are taking your seat, we also have a witness from Bell Telephone Co., from the California Public Utilities Commission, another from the National Association of Regulatory Commissions, and the People's Counsel of the District of Columbia. I cannot guarantee we will get to all these people, but we will try.

One last caveat. We are operating in the House under severe time constraints. I do hope that each and all of the witnesses will make their points succinctly. You need not worry about hurting our feelings, just go ahead and say what you want.

Mr. Ferguson.

TESTIMONY OF M. CARR FERGUSON, ASSISTANT ATTORNEY GENERAL, TAX DIVISION, DEPARTMENT OF JUSTICE

Mr. FERGUSON. I do have a short written statement which I would like to submit for the record.

Mr. DANIELSON. Without objection, Mr. Ferguson's statement will be received in the record in its entirety. It is received. Sir, you are free to proceed.

[The information follows:]

STATEMENT OF M. CARR FERGUSON, ASSISTANT ATTORNEY GENERAL, TAX DIVISION

Mr. Chairman, I am pleased to present the views of the Department of Justice on H.R. 229, a bill to amend title 28, United States Code, to provide for a court to issue a declaratory judgment in certain cases involving public utilities.

Under present law, Federal district courts generally do not have jurisdiction to issue declaratory judgments with respect to tax disputes. This long-standing policy is embodied in the tax exception to the Declaratory Judgment Act, 28 U.S.C. section 2201. Its purpose is to minimize judicial interference in the assessment and collection of taxes.

The only statutory exception to the bar on declaratory judgments as to federal tax disputes in the federal district courts is contained in 26 U.S.C. section 7428. This provision permits the district court for the District of Columbia (and the Tax Court and Court of Claims) to issue declaratory judgments relating to tax status determinations under sections 501(c)(3), 509(a) and 4942(j)(3) of the Internal Revenue Code of 1954.

H.R. 229 would amend title 28 of the United States Code by enacting a new section 2202, which would authorize any Federal court to issue a declaratory judgment in a case of actual controversy between a utility and either the Secretary of the Treasury or a ratemaking body, with respect to the ratemaking or accounting provisions of section 46(f), 167(l), or 167(m) of the Internal Revenue Code of 1954. In the event a utility obtains a ruling from the Secretary of the Treasury as to the tax controversy (or the Secretary fails to issue a ruling within 180 days), the utility or the ratemaking body can bring suit seeking a judicial declaration as to that controversy. If such a proceeding is instituted, the utility, the ratemaking body and the Secretary would all be joined as parties.

The statutory provisions of the code which may be the subject of declaratory actions were enacted into law in 1969 (sections 167(l) and (m)) and 1971 (section 46(f)). These provisions relate to utilities' entitlement to the benefits of accelerated depreciation and the investment tax credit, respectively. Without detailing the background and reasons for their enactment, it is sufficient to note that Congress conditioned certain public utilities' entitlement to those benefits upon their adopting "normalization accounting" for ratemaking purposes. If the ratemaking body exercising regulatory authority over a particular utility's rates authorized or directed some other method of accounting, the utility would lose those tax benefits. Loss of these benefits would, of course, result in an increase in the utility's Federal tax liability.

Under present law, the determination whether a particular rate order satisfies the normalization requirements must await an Internal Revenue Service audit of the affected utility's income tax return. If the Service determines that the rate order violates the normalization rules, it will adjust the utility's tax liability to reflect a disallowance of accelerated depreciation or investment credits. The utility may contest that determination in the Tax Court prior to payment, or pay any resulting tax assessment and file suit for a refund in either a federal district court or the Court of Claims. As a consequence, there is often a significant time lag between implementation of the rate order and a final judicial determination of its tax significance. The clear intent of H.R. 229 is, of course, to provide a more timely judicial determination of the tax issues presented by a rate order.

While we appreciate the difficulties a utility can face when there is uncertainty about the tax effect of a rate order, there are strong public policy arguments supporting the limitations on the availability of declaratory judgements. Accordingly, we are generally reluctant to endorse any legislation that will lower the bar to declaratory actions involving Federal tax matters, absent a clear and convincing case that such legislation is necessary and would achieve its purpose.

We are not certain at this time that such a showing has been made in the case of H.R. 229, and are not confident that the proposed declaratory remedy cures the problems now facing the regulators and the utilities. We are not entirely sure that the proposed declaratory remedy will meaningfully accelerate the determination of tax liability, or be utilized by either the utilities or the regulators. Under the bill as presently drafted, regulatory agencies might well place rates into effect before declaratory proceedings, which could be protracted, have been concluded. If the regulators do permit the rates to go into effect prior to the declaratory judgment being issued, the utilities will be in effectively the same position they would have been in even without the proposed legislation.

Of course, amending H.R. 229 to authorize the Federal court hearing the declaratory action to stay rate orders pending its decision would avoid such a possibility. But any proposal granting the Federal court such a power poses yet another set of problems. Under time-honored Federal policies codified in the Johnson Act, 28 U.S.C. section 1341, the Federal courts have been directed not to intervene in local rate cases except under certain exceptional circumstances. It would appear that the tax matters here do not generally fall within the areas now exempted from the Johnson Act bar. Thus, any amendment to the present proposal to permit the issuance of a stay might well seriously undermine the Johnson Act policies. Without more information as to the reaction local regulators might have as to the creation of such a new exception to these Federal polices, we are somewhat loath to endorse such an amendment.

Further, we are not confident that the affected utilities and regulators would actually employ the newly created procedures proposed by H.R. 229, or whether this legislation might in the end stimulate an undue amount of litigation. In the latter case, both the utilities and the regulators might wish the assurance of a judicially determined tax outcome before a rate order is placed into effect. The existence of a declaratory action therefore might invite ratemaking bodies to test the outer limits of the normalization requirements, with a burdensome number of declaratory actions the result.

On the other hand, there is a real possibility that either the utilities or the regulators (or both) might be unwilling to suffer the ratemaking delay a declaratory action would inevitably entail. In this case the legislation would be essentially a dead letter. Again, until we know more about the utilities' and the regulators' view of the proposed legislation, as well as third parties who might claim an interest in the matter, we are reluctant to express a fixed opinion.

In sum, while we appreciate the problem the bill purports to address, we have various reservations regarding the bill. Accordingly, we prefer at this time to withhold making a recommendation concerning enactment of this legislation until the dominant parties, the various ratemaking bodies and public utilities throughout the nation, have analyzed the impact of the bill upon them, and until its ramifications with respect to effective tax administration have been fully explored.

The Department of Justice therefore reserves judgment concerning whether this bill should be enacted until we have had an opportunity to hear and evaluate the responses of the above parties.

Mr. FERGUSON. Thank you, Mr. Chairman.

Rather than read the statement, I will try to summarize its contents very briefly, having in mind the subcommittee's very busy day.

The Department of Justice recognizes that the public utilities and indeed their regulating agencies have a severe problem in trying to operate in the face of a number of imponderables, one of which is the Internal Revenue Code, which can so drastically affect the tax consequences to the utilities.

The principal concern, I believe, of the utilities in California which have suggested the necessity of this provision has to do with the investment credit and accelerated depreciation provisions of the Internal Revenue Code. Particularly at issue are the requirements in those provisions for qualifications for the tax dispensations they articulate, that the method of determining utility rates be calculated with respect to the availability of the tax credit and the tax benefits from accelerated depreciation by what is referred to in the code as normalization, or spreading out the effect of the tax benefits over the life of the assets which have earned the tax benefits.

Mr. DANIELSON. If the gentleman will yield for a moment. I want to inform the committee members present that the vote which has just been noticed is to pass upon whether or not we approve yesterday's hearings. If you want to leave to approve that vote I will leave that to the discretion of everyone.

You may proceed.

Mr. FERGUSON. Under the time-honored principles, the Federal courts are prohibited from intervening in rate cases except in extraordinary circumstances. I think there is good reason for this. Just as the Internal Revenue Code prohibition on injunctions against tax collection are designed to permit regular and speedy assessment and collection of our revenues, so the nonintervention of the Federal courts in rate matters is, except in extraordinary situations, necessary to effect speedy setting of rates. There are a number of imponderables which go into the setting of rates. We must submit, until we have heard from representatives of regulatory agencies, we hesitate to say that the tax impact of the provisions which I just very briefly described are of such an extraordinary nature that the intervention by the Federal court system would seem appropriate in the setting of rates.

Now, there is a countervailing, or I should say a supporting, concern of the Department, and that is the general undesirability of proliferating declaratory judgment proceedings. The objection to these proceedings which Congress has shown historically in the case of tax determinations, I think springs from a concern which is akin to the general aversion to injunctions with respect to assessment and collection: that is, the inappropriateness in most cases of deciding tax issues before the fact, especially since there is a well-developed administrative rulings procedure in the Revenue Service for issuing advance rulings as to how the Revenue Service will react. That procedure is administrative and of course subject to subsequent review. We suggest the time for that review in most cases is after the transaction has been carried out, a return has been filed, and an orderly examination of the return has been made and an opportunity exists to sift out the issues between the parties, and then to litigate with respect to either an alleged overpayment or with respect to an alleged deficiency owing.

Departures from those traditional methods of litigation have been few. It is true that in the last several years, Congress usually, at the instance of Ways and Means rather than Judiciary, has expanded the numbers of exceptions where declaratory judgment proceedings have been permitted, and I refer to some of those in our formal statement.

The experience in the few years since the courts have been faced with these declaratory judgment proceedings seems to be confirming our concerns about declaratory judgments. Namely, if you can litigate before the fact, there is a tendency for taxpayers to push up against the very boundaries of what is permissible to try to explore just how far they can design transactions to avoid tax impact, and second, the amount of litigation is expanded to the extent that the courts are burdened with effectively acting as administrators as much as judges.

I think there are circumstances where departures from the general aversion to declaratory judgments have always in a good cause, and certainly in at least one of those cases, the declaratory judgment reviewing negative rulings with respect to section 367 of the IRS Code, it is almost mandatory for the courts to do this if a transaction is to go forward at all.

But the burden has been significant. For example, while the Tax Court has annual filings in the neighborhood of 10,000 cases a year and there are only 16 judges, the burden is manageable with respect to cases involving actual deficiencies in transactions that are closed because most of those cases can be settled.

With respect to declaratory judgments, because the transaction is in the future and because the dispute involves the application usually of new legal principles or complicated principles to novel sets of facts, the issues are almost never resolved without a full hearing, after which court is required to write an opinion.

I am told by the Chief Judge of the Tax Court that within the last year, virtually the full time of 1 of the 16 judges was absorbed by the new declaratory judgment procedures. One out of sixteen is a substantial incursion on the court's time, and I would submit that the declaratory judgment procedures in the district courts will gradually have the same kind of burdensome effect.

Therefore, we are very slow to support declaratory judgment innovations. We do recognize that in the case to which H.R. 229 is addressed, there are good arguments and reasons why this situation might be so exacerbated that Congress would be justified in moving once again in this direction. But we do feel before a final position can be recommended by the administration to Congress, that we should hear, not only from the regulated utilities, but from spokesmen for some of the commissions whose responsibilities it is to set rates.

That is really all I have to say in my statement. I will be very pleased to answer any questions.

Mr. DANIELSON. Thank you very much, Mr. Ferguson. My colleagues will be back very shortly. They are complying with the rollcall request.

You have stated in your final comment that before a final position is recommended by the administration, you feel you ought to hear the opinions of interested persons in the regulatory agencies, et cetera.

Mr. FERGUSON. Yes, sir.

Mr. DANIELSON. I certainly have no quarrel with that. I do want to impress upon the Department of Justice, if I can, that I feel maybe you should make a departure from normal procedures here and get a prompt expression of opinion. It has been my experience these things can drag for months and years, and meanwhile, the patient is languishing in an unacceptable position. I think to be responsible, we should come to our answer as quickly as possible. I do not deny we need the answer, but I hope I can build a fire under all those who wish

to express themselves and have them provide us and the administration with all the information possible so that we can resolve this as quickly as possible.

The gentleman also mentioned this might result in an incursion on the time of our district courts, as it apparently has on the time of the tax courts.

That is a serious situation, but I submit it is the proper function of the courts to resolve cases and controversies, and I do not know why we should deny any of our citizens relief when it is needed when it means simply that the judges will have to work a little harder.

Mr. FERGUSON. That goes, Mr. Chairman, to the kind of relief. One of the primary reasons for the bill, I take it, is that it is hoped that speedier relief will be provided than would be provided by the traditional forms of tax litigation.

Mr. DANIELSON. That is correct.

Mr. FERGUSON. I think that is a point we will be examining very closely. Our concern is that the time required to resolve a tax issue in the posture of a declaratory judgment action, having in mind appeals, either by the utility or the commissioner, might very well approximate the time required already to resolve it, save for the additional year or 2 years required for filing the first return under the system and having it audited and processed.

Given the delays in the ninth circuit now, we estimate the time required will be close to 5 years.

Mr. DANIELSON. I think it is closer to 3 years and three-quarters. I've talked to the chief judge of the ninth circuit, and he tells me they should have the cases pending under control in less than 4 years.

Mr. FERGUSON. I was counting the district court time as well.

Mr. DANIELSON. I do not quarrel with anything you have said. You have been most helpful, and in case it is not apparent, although I think it is, I want to assure everybody that I have a totally blank mind on this subject and will approach it as fairly as I can, and I know my colleagues will also.

Mr. FERGUSON. Thank you, Mr. Chairman.

Mr. DANIELSON. One other point concerns me. Long ago, I did try quite a few lawsuits, many involving taxes. And I know that traditionally, a citizen was required to file his return, pay his taxes, and then sue for a refund. That is fine when you are talking about taxes of the magnitude of my own, but when you get into taxes of a public utility, you cannot ignore that the vast amount of money being immobilized is unacceptable. We have to work out a better solution. I will lean on you, sir, for all the help you can give us.

Mr. FERGUSON. Mr. Danielson, we will certainly study the testimony adduced before your subcommittee very carefully.

Mr. DANIELSON. You will have no trouble getting any copies of things we receive. Maybe we will become well acquainted.

[The following letter was submitted for inclusion in the record:]

U.S. DEPARTMENT OF JUSTICE,
ASSISTANT ATTORNEY GENERAL LEGISLATIVE AFFAIRS,
Washington, D.C., September 12, 1979.

Hon. GEORGE E. DANIELSON,
Chairman, Subcommittee on Administrative Law and Governmental Relations, Committee on the Judiciary, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In testimony before your subcommittee on August 2, 1979, M. Carr Ferguson, Assistant Attorney General, Tax Division, reserved judgment on H.R. 229, a bill which amends Title 28, United States Code, to authorize

the issuance of declaratory judgments in certain cases involving public utilities, until the dominant parties, the various ratemaking bodies and public utilities, could present their views, and until we had an opportunity to analyze its impact on effective tax administration.

His testimony emphasized the Justice Department's strong support of the long-standing bar on declaratory judgments in tax disputes. Accordingly, we were reluctant to endorse any proposal, such as H.R. 229, which would provide an exception to this important principle, absent a clear and convincing showing that the proposal was necessary. In accordance with your request that we come to an early decision whether we would support the bill, we have given careful consideration to the information garnered by your hearings, and have come to the conclusion that we cannot support this bill.

To begin with, we would note that the only instances in which Congress has heretofore permitted the maintenance of declaratory actions with respect to Federal taxes were those in which declaratory actions represented the only practical means of securing judicial review of the Internal Revenue Service's position on a tax issue.

That clearly is not the case with respect to the normalization issues here. Rather, as is the case with virtually all taxpayers, utilities can adopt (or their regulators can require them to adopt) whatever accounting techniques they believe best serve their interests. If the Internal Revenue Service determines that those techniques do not satisfy the requirements of the Internal Revenue Code, the utilities and regulators are not legally or practically barred from adopting the accounting techniques. Rather, in distinct contrast to the situations as to which tax declaratory judgments are now available, they may follow whatever course they desire, and any contrary position adopted by the Internal Revenue Service may be challenged in an appropriate deficiency or refund action.

Nonetheless, we deem it unlikely that matters will often come to such a pass in the case of the normalization issues concerned here. As is indicated by the *Pacific Telephone* case, the Internal Revenue Service, through its ruling process, is willing to give utilities (and regulators) advice as to the tax consequences of various rate orders prior to the time those rate orders are placed into effect. If the utilities, regulators or the State courts which review the rate order deem that advice well founded, the rate order can be amended. If, on the other hand, they believe that their own interpretation of the code requirements is valid, they can choose to disregard it.

History would seem to indicate that either the utilities and regulators have chosen to follow the Internal Revenue Service's interpretation of the code requirements or, if they have chosen to adopt another path, they have convinced the Service that such a course is statutorily permissible. Prior to the California telephone company cases, all normalization issues had apparently been satisfactorily resolved at the administrative level. And, as yet, there has not been the rush by other regulators to follow California's lead in this area, which we had initially feared. Thus, apart from the California cases, the normalization requirements remain a relatively controversy-free part of the code. We doubt if that trouble-free record could be maintained if H.R. 229 is enacted. Rather, we fear that H.R. 229 would bring in its wake a substantial tide of law suits seeking to test the boundaries of the law.

Accordingly, we do not believe that the evidence cited by those who support the bill establishes that there is a wide-spread problem that requires a declaratory solution, or that a declaratory action is the appropriate method to solve whatever problem exists.

Our opposition to the present bill is, however, motivated by more than our belief that it does not fit the pattern of the exceptions previously enacted or that it might engender additional litigation. In our view, passage of H.R. 229 would create a dangerous precedent. If utilities are afforded declaratory relief regarding compliance of a rate order with the normalization requirements, even though they have ready access to the courts to challenge an adverse Service determination on this issue, then it might well be argued that the utilities should also be afforded declaratory relief regarding any Federal tax questions that might affect a rate order. Further, other taxpayers in regulated industries, who also are similarly situated, might properly argue that they should be allowed to obtain similar declaratory relief regarding orders issued by their respective regulatory bodies.

Indeed, this seems to be the case. NARUC has officially endorsed H.R. 229, with proposed amendments which, in pertinent part, would provide that the declaratory relief should be extended to encompass all the Federal tax consequences of a rate order, and not merely whether the rate order complied with the normali-

zation requirements of the Internal Revenue Code. Also, the American Gas Association (AGA), representing the natural gas transmission and distribution industry, has presented written testimony contending that H.R. 229 should be extended to apply to all code provisions respecting eligibility for special capital recovery treatment, citing H.R. 4646, the Capital Recovery Act of 1979, as an example.

That these contentions have been advanced during the early deliberations on H.R. 229 strongly suggests that H.R. 229, even if it should pass as presently proposed, would constitute only the first of many similar assaults upon the policies proscribing declaratory judgments in tax matters. We cannot view that prospect with equanimity. As Mr. Ferguson indicated in his testimony before your subcommittee, we view the bar to declaratory suits on tax issues as critical to the efficient administration of the tax laws. H.R. 229 would, we believe, constitute an unprecedented weakening of this bar, which we cannot endorse. For these reasons, we oppose the enactment of H.R. 229.

The Office of Management and Budget has advised this Department that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

ALAN A. PARKER,
Assistant Attorney General.

Mr. DANIELSON. The next witness will be Robert V. R. Dalenberg, vice president and general counsel, Pacific Telephone & Telegraph Co.

TESTIMONY OF ROBERT V. R. DALENBERG, VICE PRESIDENT AND GENERAL COUNSEL, PACIFIC TELEPHONE & TELEGRAPH CO.

Mr. DALENBERG. I thought I must just talk to you a little bit about the nature of this problem and the way we perceive the reasons why we very strongly support H.R. 229.

Mr. DANIELSON. Without objection, your statement will be received in its entirety, and you, too, are free to proceed in whatever you consider to be your most effective manner.

[The information follows:]

SUMMARY OF STATEMENT OF ROBERT V. R. DALENBERG, PACIFIC TELEPHONE & TELEGRAPH CO.

We strongly support H.R. 229. The bill authorizes a declaratory judgment in Federal courts to determine how the Federal income tax law provisions on investment credit, accelerated depreciation and shorter tax lives are to be applied under a particular state or Federal ratemaking order.

Under present law, an appeal of a regulatory order will not bind the IRS. The utility can seek an IRS ruling on the effect of the order, but there is no court review of an IRS ruling, and the regulatory commission can ignore it, forcing the utility to await completion of IRS audits and subsequent tax litigation. Meanwhile, substantial potential tax liabilities will accumulate. For example, an estimated $2.6 billion in tax liabilities will have accrued by the end of 1983 in Pacific Telephone's present case in California.

Congress has created important tax incentives through the investment credit and accelerated depreciation but has not provided a forum to promptly determine eligibility for these tax provisions. H.R. 229 affords a procedure for expeditiously resolving conflicting interpretations of Federal tax law in a proceeding which is binding on the utility, the regulatory commission and the IRS.

We propose that an additional provision be included in H.R. 229. If during the 180 period awaiting an IRS ruling or during the pendency of the declaratory judgment proceeding the regulatory order becomes effective, there may be no way for the ratemaking commission to cure any tax ineligibility. Therefore, to ensure that the question of eligibility is preserved until a declaratory judgment is rendered, the court should have the power to grant injunctive relief until it has issued its decision.

STATEMENT OF ROBERT V. R. DALENBERG, VICE PRESIDENT AND GENERAL COUNSEL OF THE PACIFIC TELEPHONE & TELEGRAPH CO.

Mr. Chairman, my name is Robert V. R. Dalenberg. I am Vice President and General Counsel of The Pacific Telephone and Telegraph Company.

I have been employed by The Pacific Telephone and Telegraph Company since December of 1972, first as Assistant Vice President, then as Associate General Counsel and since 1976 as Vice President and General Counsel. Prior to my coming to the Pacific Company, I was the General Attorney in charge of litigation for the Illinois Bell Telephone Company.

Mr. Chairman, I appreciate very much the opportunity to appear before this Subcommittee to discuss the bill, H.R. 229.

My purpose here today is to indicate the strong support of the Bell System Companies for the proposed legislation that would authorize declaratory judgment actions in United States District Courts to determine whether or not a utility will be eligible under particular rate orders for accelerated depreciation, the use of shorter depreciation lives and the investment tax credit. There is urgent need for such legislation in order to ensure that the Congressional purpose behind Sections 167(l), 167(m), and 46(f) is not frustrated. In California there have been and continue to be serious difficulties in not being able to resolve inconsistent state and federal interpretations of these Federal income tax law provisions. I will describe those difficulties and will also refer to several technicial corrections that should be made to H.R. 229 and dicuss a small but important addition to the proposed legislation that would ensure that the rights of the parties would be protected while a party is seeking a declaratory judgment as proposed in the legislation.

THE PROPOSED LEGISLATION

H.R. 229 would enable a utility or a regulatory commission to obtain an early, binding determination between all parties where the Internal Revenue Service and a state or Federal regulatory commission make inconsistent determinations with respect to the eligibility of a utility for the investment tax credit, accelerated depreciation, or shorter tax lives under a particular rate order.

At present, if a regulatory agency issues a rate order which includes a questionable interpretation of the requirements of federal tax law, Congress has provided no procedure for a determination which will bind the regulatory agency, the Internal Revenue Service and the utility to a decision as to whether the regulatory agency correctly applied the tax law. Appeal by the utility of the agency's order through the state court system will not bind the Internal Revenue Service. On the other hand, there is no court review of an Internal Revenue Service ruling and a judicial determination of eligibility for these tax benefits must await completion of Internal Revenue Service audits many years after the regulatory agency's decision has gone into effect. During this time, the utility will have accured enormous federal tax liabilities. If, as in California, the regulatory commission and reviewing court view Internal Revenue Service rulings as of no consequence, the utility/taxpayer is placed in a most difficult position. When state regulatory bodies charged with setting rates for utilities interpret these eligibility requirements differently from the manner in which they are interpreted by the Internal Revenue Service, the utility faces a severe problem.

H.R. 229 would enable such conflicts to be resolved quickly. The inability at present to require the state and federal authorities to adhere to a consistent interpretation of the Code's eligibility requirements is most damaging to utilities' financial health. Continuing uncertainty over the issue only exacerbates the problem.

THE TAX BASIS FOR STATE REGULATORY INTERPRETATION OF THE ELIGIBILITY CRITERIA

The eligibility criteria involved here are primarily associated with two tax incentives that were expressly intended by Congress to stimulate modernization and expansion of capital investment in both regulated and non-regulated industries. (The eligibility criteria relating to shorter tax lives are substantially identical to the criteria relating to the use of accelerated depreciation.) These incentives are provided by the provisions permitting the use of accelerated methods of depreciation (Section 167) and the investment tax credit (Sections 38 and 46).

As originally enacted, the 1954 Code contained no special provisions relating to the treatment of accelerated depreciation for regulated utilities. In the absence

of explicit federal limitations, the stated Congressional intent of stimulating the economy by fostering capital formation was partially thwarted in ensuing years. Since federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the tax deferral resulting from accelerated depreciation as a reduction in cost of service, and therefore lowered rates. In this way, the agencies immediately passed through to customers the amount of the current tax deferral. This practice, known as "flow-through" ratemaking, prevented the accumulation and investment of capital that Congress had intended when it enacted the 1954 Code. By reducing the utility's income the practice also reduced the amount of federal taxes to be paid.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, § 167 was amended as part of the Tax Reform Act of 1969. Under newly-enacted § 167(l), a utility which had not previously used accelerated depreciation for federal tax purposes could thereafter use accelerated depreciation *only* (1) if the utility used the "normalization" method of accounting in its books of account *and* (2) if the regulatory agency used the normalization method of setting rates.

Under normalization as prescribed by the Code and Regulations, (1) a utility's tax expense for ratemaking purposes must be computed as though book (i.e., straightline) depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service.

By allowing utilities to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: First, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital until paid to the Internal Revenue Service, and second, to avoid the additional loss of Federal tax revenues that results when flow-through ratemaking is imposed.

Similarly, when Congress reenacted the Investment Tax Credit in 1971 and, again, when the credit was increased in 1975, Congress provided that the credit would be available to such taxpayers only if the ratemaking method met the specific requirements of the statute (Section 46(f)). Thus the provisions of Sections 167 and 46 of the Internal Revenue Code are unique in that they condition receipt of the Federal tax benefits on a particular form of ratemaking established by the State or Federal regulatory commission having jurisdiction over the regulated utility's rates. This results in a sitnation where the taxpayer is not in control of its own tax liabiiity. Tax iiability is dependent upon the action taken hy the reguiatory commission.

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The taxpayer's inabiiity to control its tax liahiiity with respect to these benefits is compounded hy the practical problem that the audits of tax returns of large utilities are not compieted for several years after the returns are filed. For instance the audit of the Beil System's consoiidated returns for 1974 is only now nearing completion. This means the utiiities face a substantial lag between the time a rate order is entered and the time the Internal Revenue Service re-

views whether the order is consistent with the eligibility criteria of Sections 167 and 46.

THE EFFECT OF THE STATE REGULATORY ELIGIBILITY DETERMINATION

When a state regulatory commission makes rates, it must construe the Internal Revenue Code and Regulations and determine whether or not its ratemaking method complies with the federal criteria for eligibility for the tax benefits. Under the present law, the utilities and the regulatory commissions have no satisfactory way of determining whether a particular ratemaking method meets the eligibility criteria of the Code. This means that if a commission makes a mistake and fails in one manner or another to follow the requirements of the Code, that mistake may be perpetuated for many years before the Internal Revenue Service audit. And if the commission disagrees with the audit's findings and insists upon the utility litigating the issue, many more years may go by before the litigation with the Internal Revenue Service is resolved. Thus, although a regulatory commission may in good faith seek to retain eligibility for the utilities wich it regulates, it may create very large tax liabilities by making an error as to the requirements of the Code. And, those very large tax liabilities will continue and grow for as long as the commission continues the particular ratemaking method it has chosen.

Under present law, if there is doubt whether the ratemaking method of the regulatory commission conforms to the eligibility requirements, the utility may seek a ruling from the Internal Revenue Service. The commission may conclude that the ruling is not binding and may insist that the issue of eligibility be litigated before the commission will concede the validity of the Internal Revenue Service view and change its method of making rates. Such litigation must await the audit and assertion by the Internal Revenue Service of a tax deficiency. The time-consuming effect of this manner of testing the regulatory method imposed on the utility could only result in severe financial damage to the utility and its customers.

While most commissions have followed a conservative path with respect to these tax benefits to ensure eligibility for the utilities they regulate, the California Commission has not. In California, the Commission has entered orders with respect to at least four utilities which embraced ratemaking that the Internal Revenue Service has ruled is inconsistent with the requirements of the Internal Revenue Code.

THE SITUATION IN CALIFORNIA

The situation that Pacific Telephone has had to contend with vividly illustrates the problem that utilities may face when the policy of the state commission is at odds with the policy of Congress in enacting these tax incentives. The California Commission adheres to a general policy of not permitting the tax incentives to assist the utilities as Congress intended, but of "flowing through" such incentives to immediately reduce rates.

In 1970, Pacific Telephone sought assurance from the California Commission that it would use the normalization method of accounting required by Internal Revenue Code Section 167(*l*) in making rates for Pacific so that the Company would be eligible to take accelerated depreciation for federal income tax purposes. The Commission entered an interim declaratory order in which it held that it would use the normalization method. That order was reversed by the California Supreme Court on procedural grounds. The matter was subject to further hearings before the California Commission an in 1974 the Commission again held that it would use the normalization method of accounting. This second order was reversed by the California Supreme Court. The Court did not reach the merits of the case or construe the Internal Revenue Code. The Court remanded the matter back to the California Commission for further hearings and the Commission instituted an additional series of hearings to determine whether or not it would adhere to normalization.

Finally, in 1977, the Commission entered an order again asserting that it desired to make Pacific Telephone eligible to use accelerated depreciation and the investment tax credit and it would attempt to make its rates in accordance with the normalization method of accounting. However, the Commission did not embrace the traditional and well understood method of accounting or of ratable flow through of the investment credit, but instituted two newly invented accounting procedures which resulted in a reduction in rates below those made in accordance with the generally understood requirements of the Internal Revenue

Code. In this way it achieved a substantial "flow-through" of both of the tax benefits.

Special tax counsel for Pacific Telephone rendered the opinion that the new methods of accounting were not consistent with the requirements of the Code and Pacific was forced to seek review by the California Supreme Court. In the meantime, Pacific sought Internal Revenue Service rulings as to the Decision's effect on Pacific's eligibility for the tax benefits. The Internal Revenue Service, in two private rulings issued in June and July of 1978, held that the Commission's order will disqualify Pacific Telephone from claiming accelerated depreciation and investment tax credit. The California Commission refused to participate in the ruling request and has subsequently ignored the Internal Revenue Service rulings. The California Supreme Court denied Pacific Telephone's Petition for Review of the rate decision without opinion. Review was then sought in the United States Supreme Court. The Solicitor General of the United States supported the request for review and advised the Court that the Commission action destroyed Pacific's eligibility for the tax benefits. He further pointed out that:

"As matters now stand, the decision below and the Internal Revenue Service are on a collision course that threatens the financial stability of all regulated utilities in California [1] and potentially affects other similarly-sitnated companies."

The Supreme Court, however, denied the Petition for Certiorari, with two justices voting to grant review.

Pacific then sought a further stay of the Commission's decision from the Commission itself until the tax issue could be finally established with the Internal Revenue Service in the normal manner following audit of the tax return. The Commission refused. Pacific then filed a "last resort" complaint in the United States District Court, seeking to enjoin effectuation of the Commission's order until litigation with the Internal Revenue Service could be completed or, as an alternative, seeking a declaratory judgment on the eligibility issue. The District Court denied Pacific's motion for a preliminary injunction. The District Judge found that Pacific had shown that it would sustain irreparable injury if the Commission decision is placed in effect, but concluded his hands were tied by the doctrine of res judicata. On July 18 the federal Court of Appeals affirmed. The Commission and certain intervenors opposed Pacific in these proceedings even though the Internal Revenue Service again filed a brief, in response to a reqnest from the Conrt, asserting that the Commission decision destroys eligibility for the tax benefits.

At this point, although we have made every attempt, no court has reviewed the merits of the Commission's doubtful construction of the Internal Revenue Code.

THE ECONOMIC EFFECTS OF THE POSSIBLE LOSS OF ELIGIBILITY

The Commission decision directly recomputes the Company's rates from August 1974 forward and thus directly determines eligibility for the tax benefits beginning in 1974. The rates are reduced on the assumption that eligibility for the tax benefits continues. The potential tax liability represented by the accrual of deferred taxes associated with accelerated depreciation and with the investment tax credit claimed since the beginning of 1974 is estimated below.

	Reserve for deferred taxes	Investment tax credit	Annual total
1974	$91, 132, 000	$26, 313, 000	$117, 445, 000
1975	106, 454, 000	69, 675, 000	176, 129, 000
1976	116, 428, 000	73, 847, 000	190, 275, 000
1977	131, 315, 000	84, 454, 000	215, 769, 000
1978 (estimate)	142, 095, 000	103, 875, 000	245, 970, 000
1979 (estimate)	146, 485, 000	122, 589, 000	269, 074, 000
1980 (estimate)	166, 704, 000	128, 793, 000	295, 497, 000
1981 (estimate)	188, 132, 000	140, 369, 000	328, 501, 000
1982 (estimate)	212, 039, 000	150, 795, 000	328, 501, 000
1983 (estimate)	262, 986, 000	158, 049, 000	421, 035, 000
Grand total	1, 563, 770, 000	1, 058, 759, 000	2, 622, 529, 000

[1] While 3 California utilities use normalization for accelerated depreciation, we understand almost all California utilities have elected opton 2 with respect to some or all of the investment tax credit and thus are potentially impacted by the Commission's accounting methods.

These tax benefits have been invested in plant and equipment which are serving the public. The tax benefits have been a clear incentive to capital formation as the legislation intended. In fact these tax benefits have provided a substantial part of the funds used by Pacific to fund its construction budget which in 1978 was over two billion dollars. If the Commission's action results in the taxes becoming currently due, Pacific would be required to borrow heavily to meet this obligation. Pacific's ability to borrow might be exhausted in arranging to pay such tax liability, and its ability to sell equity would be practically foreclosed. This is particularly true if the entire back tax liability must be paid at one time of over a relatively short period. The refunds and rate reduction order by the Commission and the back tax liability could disable Pacific from keeping up with the demand for telephone service. The number of held orders for customers who want but cannot be provided with service because of lack of plant capacity would then increase dramatically. Under such circumstances, many long distance calls would not be completed and many more calls would take longer to complete. Employment at Pacific would obviously be affected; other adverse economic effects would ripple through the economy.

THE PROBLEM CAN BE RESOLVED BY H.R. 229

Congress has created a unique and very special situation in which it has placed eligibility for accelerated depreciation and the investment tax credit out of the control of the taxpayer. The taxpayer's eligibility is under the control of the state regulatory commissions. With such control, the state regulators can either accidentally or purposely endanger a utility's eligibility for the tax benefits. Because the present federal statutory scheme for determining tax liability was not enacted with this situation in mind, the taxpayer is precluded from resolving its own tax liability in a manner that would permit the regulator to correct an improper order and avoid the loss of eligibility. This places taxpayers in a position of severe jeopardy. If the liability for back federal taxes mounts over successive years because of an improper ratemaking technique required by the state regulatory agency, it is the utility that faces the impact of suddenly having to pay the large back taxes. The resultant costs will be borne by the customers.

There is no effective remedy in the state courts. The state courts may review the commission's decision, but the state court determination is not binding upon the Internal Revenue Service. In addition, the state courts are not accustomed to construing the Internal Revenue Code and are reluctant to do so. While it should not be held to apply to this situation, the Johnson Act (28 U.S.C.A. 1342) largely precludes federal court review of state rate orders and was relied upon by the California Commission as preventing review. In addition, it is the position of the Internal Revenue Service that the present Federal Declaratory Judgment Statute (28 U.S.C.A. 2201) precludes declaratory relief in this situation, although we do not agree with this view. As a practical matter, it may be only after ordinary avenues of review have been shown to be inadequate to protect the utility from the adverse effect of a disagreement between the federal and state governments as to the meaning of the federal tax law that the utility has any chance of having the Federal Courts recognize the statutory and judicial exceptions to the Johnson Act and the Declaratory Judgment Act and intervene. By then, as shown by your situation in California, the utility's position is precarious for it is facing an enormous back tax payment which could disrupt both local and interstate services.

Congress through accelerated depreciation and the investment tax credit, has created important tax incentives, but has failed to provide a federal forum to promptly determine eligibility for the tax benefits. To remedy this situation, we suggest that the federal courts be expressly permitted to render declaratory judgments as to whether or not a utility will be eligible for accelerated depreciation or the investment tax credit under particular rate orders. The judgments should be binding upon the Internal Revenue Service, the regulatory commission and the utility. Permitting this would not run counter to the purposes of either the Federal Declaratory Judgment Statute, the Johnson Act or the provisions protecting the collection of federal taxes.

No interference with federal revenue collection would result from permitting prompt determination of questions of eligibility for the tax benefits. In fact, such prompt determination of eligibility questions would facilitate proper revenue collection. The Johnson Act is designed to prevent the federal courts from reviewing state rate orders when there exists prompt and adequate state court review. Under present law there is no effective review of the eligibility issues,

for the state courts cannot bind the Internal Revenue Service. A federal declaratory judgment remedy would not inhibit effective state regulation. Quite the contrary, for such regulation would be assisted if the purely federal issue of eligibility under the Internal Revenue Code could be resolved properly by the federal courts.

A declaratory judgment remedy such as is proposed in H.R. 229 would provide a expeditious way to resolve such controversies between the utility, a regulatory body and the Internal Revenue Service over the correct application of Sections 46(f) and 167(l) of the federal tax law. Had such declaratory judgment legislation been in effect, Pacific Telephone long ago could have obtained a resolution in the federal courts as to its eligibility for the tax provisions under the Commissions order which would have bound the California Commission. Pacific Telephone and the Internal Revenue Service. This legislation is badly needed.

TECHNICAL CORRECTIONS AND A SUGGESTED ADDITION TO H.R. 229

Attached as an Exhibit is a copy of H.R. 229 with several minor technical corrections to the present language noted thereon.

We would also propose additional language in the statute to insure preservation of the eligibility question. H.R. 229 may not ensure that the tax eligibility question is preserved for the Federal Court to hear. It is possible that a regulatory order which arguably jeopardized tax eligibility would become effective during the pendency of the declaratory judgment proceeding (including the 180-day period awaiting an Internal Revenue Service ruling) or before a Commission could reconsider its action in the light of the declaratory judgment. For example, the regulatory commission that opposed the Congressional purpose might not stay its rate order. If the regulatory order has already gone into effect, there may be no way for the regulatory body to cure the ineligibility. Possible disqualification for the tax benefits during the time prior to and during the pendency of the Federal Court action should be avoided by authorizing the Court to grant injunctive relief until the Court has issued its decision and, if necessary, have in effect remanded its order to the agency. Our proposal would be to add the following sentence at the end of Section 2202(a) of H.R. 229:

"Any party may obtain injunctive relief when and under the same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by the courts of equity."

CONCLUSION

At present the utilities and the regulatory commissions are without an effective remedy. There should be a federal forum to promptly decide the federal question of eligibility for the tax benefits. Unless Congress provides for such a remedy, many utilities may suffer severely when unanticipated back tax liability is imposed upon them or when their credit standing is downgraded because of the accumulation of contingent, unresolvable tax liabilities. Such situations can be avoided in the future if the proposed declaratory judgment legislation is enacted.

93D CONGRESS
1ST SESSION

H. R. 229

To amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 15, 1973

Mr. HANSEN (for himself and Mr. ANDERSON of Tennessee) introduced the following bill; which was referred to the Committee on the Judiciary

A BILL

To amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 2201 of title 28, United States Code, is amended

(1) by striking out ", except with respect to Federal taxes"; and

(2) by adding at the end thereof the following new sentence: "No court may make any such declaration in

Proposed Revisions

1. To correct unintentional repeal of declaratory judgment remedy for questions involving tax-exempt status.

other than actions brought under section 7428 of the Internal Revenue Code of 1954,"; and

Reason

The apparent effect of the language of H.R. 229, at lines 5-8 on p. 1 and lines 1-2 on p. 2, is to repeal the exception in the current section 2201 which authorizes declaratory judgments in cases involving the tax exempt status of certain organizations (via the reference to section 7428 of the Internal Revenue Code). The full text of the current section 2201 is as follows:

CHAPTER 151.—DECLARATORY JUDGMENTS

§ 2201. Creation of remedy

In a case of actual controversy within its jurisdiction, except with respect to Federal taxes other than actions brought under section 7428 of the Internal Revenue Code of 1954, any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought. Any such declaration shall have the force and effect of a final judgment or decree and shall be reviewable as such

It is not the intent of H.R. 229 to affect the provisions pertaining to tax-exempt status.

To avoid this result, the bill should either (1) retain H.R. 229's present format but shift the section 7428 reference to the new sentence added for the new section 2202, or (2) retain the existing language in section 2201 and simply add a reference to the new section 2202. The proposed revision is alternative (1).

a case regarding Federal taxes, except as provided in section 2202.".

SEC. 2. (a) Chapter 151 of title 28, United States Code, is amended by redesignating section 2202 as section 2203 and by inserting immediately after section 2201 the following new section:

"§2202. Certain tax controversies

"(a) A court shall issue a declaratory judgment, as provided in section 2201, in a case of actual controversy between a public utility and either the Secretary of the Treasury or a ratemaking body, with respect to the ratemaking or accounting provisions of section 167(l), 167(f), or 167(m) of the Internal Reverse Code of 1954. In any such case the pleading for a declaratory judgment may be filed only by the public utility or by the ratemaking body, as the case may be. In any such case between a public utility and a ratemaking body, the Secretary of the Treasury shall be joined as a party in the action. In any such case between a public utility and the Secretary of the Treasury, the ratemaking body concerned shall be joined as a party in the action.

"(b) No court may issue a declaratory judgment in a case, as provided in subsection (a), unless the court determines that the public utility in the case has obtained a ruling from the Secretary of the Treasury with respect to the provisions or has requested such a ruling and the Secretary of

Proposed Revisions	Reason
section 7428 of the Internal Revenue Code of 1954 and	
2. To correct typographical error.	The investment credit provision is section 46(f), not "146(f)."
3. To delete unnecessary phrase.	The phrase "as the case may be" might lead to confusion. Since it is not necessary, it should be deleted.
4. Add provision for injunctive relief.	
Any party may obtain injunctive relief when and under the same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by the courts of equity.	Authorizing the court to grant injunctive relief assures that the tax eligibility issue is preserved pending decision.
5. To correct typographical error.	The conditions for issuing a final declaratory judgment should be either that the utility has obtained a ruling or has requested a ruling which was not issued within 180 days.

the Treasury has failed to issue such a ruling within 180 days after the date on which such request was made.

"(c) For purposes of this section, the term 'ratemaking body', when used with respect to a public utility, means a State or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other similar body of any State or political subdivision thereof, which establishes or approves rates chargeable by such public utility.".

(b) The chapter analysis of chapter 151 of title 28, United States Code, is amended by striking out the item relating to section 2202 and by inserting in lieu thereof the following:

"2202. [illegible]
"2203. [illegible]"

Proposed Revisions

5. Clarify that the United States is a proper defendant.

ADD: Sec. 3. Section 1346(a) of title 28, United States Code, is amended by adding after subparagraph (a)(2) the following new subparagraph:

"(3) Any action under Section 2202 with respect to the ratemaking or accounting provisions of Sections 46(f), 167(l) or 167(m) of the Internal Revenue Code of 1954."

Reason

Amending section 1346 assures that the intent of the new section 2202(a) is fulfilled and the Treasury/IRS is a proper party defendant.

Mr. DALENBERG. Thank you, Mr. Chairman.

We do support H.R. 229 because we believe the present Federal tax law related to accelerated depreciation, and the investment tax credit creates a very unique situation. It establishes a situation where there really are three parties who have a determinant interest in the tax return of the one taxpayer, and it establishes a situation where the taxpayer does not control its own destiny, which is indeed unique in this world, in the sense that the State regulatory commission is authorized to make rates in a fashion that will either create or destroy eligibility for the tax benefits associated with accelerated depreciation and the investment tax credit.

Regardless of whether the utility advises the commission it is off on the wrong track or not, if the commission makes a mistake and did not make its rates in accordance with the Federal law's criteria, it can destroy that eligibility. The difficulty with the destruction is that it may not be known for many years.

The State commission's order may go into effect this year; the normal auditing processes followed by the IRS with large corporations such as our own necessitate a number of years of delay before the audit can be completed. While we can obtain rulings, and the Government has been very fine in trying to get rulings out as quickly as possible, that necessitates a substantial delay. Our experience in California is that the California commission does not believe the rulings of the IRS are valid and refuses to listen to those rulings and will place its orders in effect despite the Government warning the ratemaking methodology adhered to by the commission is destructive.

I think although this bill is referred to as a declaratory judgment bill, it may be wise to recognize that it is really in the nature of an interpleader. The utility is subject to control by two separate sovereigns; you have the State and the Federal Government, and the need here is to get both of those sovereigns to adhere to a uniform and consistent construction of the Federal law.

When the State regulatory commission makes its rates, it necessarily must construe and apply the Federal tax law. It is not the same situation as when it is simply in a rate case estimates the tax expense or the expense for lawyer fees or any of the other normal expenses in a rate case—its actions determine eligibility under the Federal tax laws to take these benefits on the tax return. It has its hands on that control. So it must construe the law in a very, very different manner.

When the two sovereigns are at loggerheads, the result is very, very serious, not to either sovereign, but certainly very serious to the utility.

I think the example of Pacific Telephone's dilemma here gives stark reality to the problem of not having available a procedure that permits the interpleader of the three independent parties so that the State regulatory commission may proceed on a basis where it has knowledge of what the law really is.

H.R. 229 is not designed as an appeal from a State regulatory action; it is carefully designed to provide declaratory relief so that a commission must thereafter be fully informed as to the consequences of its act.

After the declaratory relief is granted, the commission could certainly continue on the same track; it need not change anything. It continues with full knowledge of the circumstance rather than continuing on the basis that the IRS rulings may not be correct and that it disagrees as to the meaning of the Federal law. That is the important

thing that has to be done here, where the present congressional statutory scheme sets forth the manner in which the State must construe the Federal law and controls the Federal benefits for the private taxpayer.

I think if I might. I might mention the nature of Pacific's problem. In 1977, the California commission changed its accounting ratemaking methodology. It moved from a methodolgy that everyone concedes would retain elegibility for these tax benefits to a new and untried methodology, actually two, one for accelerated depreciation and one for investment tax credit, and it made its order retroactive to 1974, which by coincidence is the most current year left open to Pacific Telephone with respect to its tax problems. That year has been under audit, but that audit will not be completed until either late this summer or in the fall.

Assuming eligibility for the tax benefits exists, the commission reduced Pacific's rates substantially. The total amount of reduction based on that assumption is something over $130 million a year. At the same time, the tax liabities are accruing at an enormous rate. For this year, we estimate the tax liability, the liability that will become current and will not be deferred if the commission is mistaken, is about $269 million. For this entire period from 1974 to date, the approximate tax liability if the commission has made a mistake is about $1 billion. If we are forced, as we apparently will be, to follow the traditional judicial mechanics of resolving this problem, it will take us several more years to work our way through the tax court and the ninth circuit, as you mentioned, and by 1983, we will be staring at a problem of how we finance a $3-billion tax liability. We must finance that at the same time we try to keep up with the enormous growing need for telecommunications service in California.

That is the kind of job that an ordinary, even an extraordinary utility cannot truly accomplish.

I might close, if I may, by reading one sentence which says much better than I ever could the real problem that we have, and this sentence is from the brief that the Solicitor General filed with the U.S. Supreme Court when we ought to have the Supreme Court review the commission's ratemaking procedure.

The Solicitor General, writing very clearly, said that:

> The United States believes that the continued existence of this conflict between the Treasury and the State regulatory commission, threatens to work an enormous hardship upon the public utilities sector of the economy and to disrupt the stability of the capital markets as the affected utilities must undertake borrowings to meet these large-scale obligations.

which were either deferred or forgiven. When the utilities themselves have to go to the market to finance that, it will have unquestionably a disruptive effect.

Pacific is not the only utility subject to this problem. Every utility save one that I know of in California, at least every major utility save one, is subject to the same problem on the investment tax credit, which is very, very large. As far as I know there are three utilities in California which face the same problem with respect to accelerated depreciation, and apparently if the commission's order becomes final, there may well be other commissions around the United States which do what we call creative accounting rather than normal accounting and create the same types of problems.

So, we feel some legislation along this line which merely is designed to let each and every commission operate with full knowledge of what is the real Federal law, is needed, needed quickly and very importantly.

I would be very glad to answer any questions if anyone has any.

Mr. DANIELSON. Thank you very much, Mr. Dalenberg.

Just to recap and see where we are, I understand from your statement that very shortly your tax liability will be in the bracket of $3 billion.

Mr. DALENBERG. By the end of 1983, it will be. By that time—that is the time we project when action in the Tax Court plus appeals will be over as to the 1974 year.

Mr. DANIELSON. What is the status—you have mentioned the figures which are in the record, several hundreds of millions of dollars which are already, in issue and obviously this will continue.

Does your utility pay the tax? How are you handling it?

Mr. DALENBERG. We currently are claiming these tax benefits on our tax return along with the admonition from the commission that is what we should do. They of course have held we are eligible for that. But under the IRS, it appears we will not be eligible, and therefore they will be collecting that money back from us.

The money in the meantime is devoted immediately to capital improvements, as the Congress intended it to be devoted, to assist the service in California.

Mr. DANIELSON. Your big problem then is that you are exposed to a potential hazard that the commission's ruling will not be agreed upon by the IRS, and then you will owe a great deal more taxes?

Mr. DALENBERG. That is absolutely correct.

Mr. DANIELSON. And in addition that will dislocate your rate structure?

Mr. DALENBERG. It will mean our rate structure has been dislocated retroactively from 1974 forward, with more than $100 million a year in reduced rates on a false premise.

Mr. DANIELSON. So where our problem lies in that the Pacific Telephone Co. and other utilities know they have a tax liability, but they would like to know what that is.

Mr. DALENBERG. We would like the commission to know, the basic problem is making sure that both the States and the Federal Government are adhering to a uniform construction of the Federal law.

Mr. DANIELSON. The point being, though—maybe I started at the wrong end.

California Public Utilities Commission takes position X on what your liability is. IRS takes position Y. You may care, but you are not so concerned as to whch it is, but you would like to know and have them be the same.

Mr. DALENBERG. Not exactly. We care very importantly that we be eligible. It is very important that we know where we stand. But it is equally important that the company be eligible for these tax benefits.

Mr. DANIELSON. I do not diminish that at all. I am just trying to cut through to the focus. The fact is IRS and the public utilities commission are not in agreement.

Mr. DALENBERG. That is correct.

Mr. DANIELSON. And you want to in effect interplead them and have the court declare by declaratory judgment that this or that is the correct position.

Mr. DALENBERG. It is the only way to resolve it. As the law currently stands there is one law which ends up with a determination which is not binding on both.

Mr. DANIELSON. Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Dalenberg.

In your statement you ask that a sentence be added:

> Any party may obtain injunctive relief when and under the same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by the courts of equity.

Is injunctive relief really that critical to the substance of this bill?

Mr. DALENBERG. No. It may be a wise provision, but it is not critical to the bill. What is critical is the ability to have a declaration of actual and correct Federal law that will be binding on both sovereigns.

Mr. MOORHEAD. Is there any precedent under existing law for a declaratory judgment suit on a Federal tax matter?

Mr. DALENBERG. I think so. And I think Mr. Ferguson referred to that. Under section 501(c)(3), Congress recently approved that type of relief in situations that are unique and that can create enormous bad effects on the public, generally. There is, it seems to me, appropriate reason for that, it is particularly useful here where Congress is not interested in trying to hamstring the State commissions, not interested in interfering with the State regulatory matters, but does have a very strong Federal interest in seeing to it that the Federal tax statute and the program relating to the Federal tax subsidies is carried out uniformly throughout the United States in accordance with congressional intent.

Mr. MOORHEAD. The problem that you have is really with the State agency not really considering the taxes you are going to have to pay, and the Federal tax people asking for more than the State agency has to recognize, and you are left wtih a shortfall in between.

Mr. DALENBERG. Very serious shortfall.

Mr. MOORHEAD. And somehow you have to get that taken care of.

Mr. DALENBERG. Unless it can be taken care of promptly and in a clear manner, the utility is caught in the squeeze, and the long period of time inherent in the manner of testing your taxes just exacerbates the problem to where possibly the utility could not survive.

Mr. MOORHEAD. Will this bill authorize Federal courts to hear rate cases generally, and not strictly tax issues covered by the bill?

Mr. DALENBERG. I think not.

Mr. MOORHEAD. You think it is narrowly drawn and will take care of that issue?

Mr. DALENBERG. It is clear it is directed to the accounting requirements established by the IRS Code and by the Treasury regulations which come under that code.

Mr. MOORHEAD. Assuming that the bill is very narrowly drawn, to cover just the specified tax code provisions that are involved, why should those narrow issues not be left solely and exclusively to the ratemaking bodies in the normal appeal process?

Mr. DALENBERG. There are several reasons for that. The very overriding reason is that this is fundamentally a Federal issue that cannot be ultimately decided until the Federal courts act because what the commission does is, it makes rates saying its ratemaking should keep the utility eligible for the Federal tax, but it cannot bind the Federal

Government. So, that is merely an advisory position by the utility commission; however, it casts in concrete the tax liability of the utility. It is that hiatus, that tax liability cast in concrete by the State regulatory commission that does not have the final say on what Federal law is, that really creates a very serious problem.

Mr. MOORHEAD. Do you think there is any way the bill intrudes on the legitimate jurisdiction and authority of the regulatory commissions in the various States?

Mr. DALENBERG. I do not think so at all. It would only intrude to the same extent giving correct legal advice would intrude on anybody's discretion. The purpose of the bill is to get these three parties in one form where they can get a correct result as to what is the meaning of a fairly complicated statute.

Mr. MOORHEAD. Are there similar problems elsewhere?

Mr. DALENBERG. There have been some, but nothing to the dimension that exists in California.

Mr. MOORHEAD. If this bill is enacted in this session, will Pacific Telephone and General Pacific be able to avail itself of the procedure in the bill?

Mr. DALENBERG. In the case that is reviewed in my prepared testimony, the enactment may come too late. There still is a chance, but it looks to me as if it will come too late. However, keep in mind that the California commission is adhering to its position as a continuous matter and they entered a rate order Tuesday which I believe will embrace the same methodology. This bill would be a saving bill for California, just as soon as it can be adopted. So, it would be helpful to us immediately upon it being passed.

Mr. MOORHEAD. My time is beginning to run out. I have one more question I wanted to ask you.

One of the purposes of the bill is to speed up review on tax issues so that if a regulatory body made a mistake and deprived a utility of tax benefits, it could change its order before it became effective. What if after a Federal court found a regulatory order did make the utility ineligible, the regulator did nothing or refused to change its order, then what have you gained under the procedure this bill establishes?

Mr. DALENBERG. Then you have made it very clear that the regulator's order is inconsistent with eligibility. At that point the formal State review process can go forward also with the correct knowledge of what the Federal law is and what the effect on the utility would be. I would believe in any State that the court would reverse that kind of action. Indeed, I think the precedents in California would so indicate, and certainly the leading decision in this area, a case by the Supreme Court of Maine, would obtain.

Mr. DANIELSON. The gentleman from New Jersey?

Mr. HUGHES. Thank you, Mr. Chairman.

I am not so sure I understand totally where the irreparable harm comes in. As I understand it, in this instance it is very difficult for the utility to make tax decisions and to apply to the public utilities commission to try to determine its rate base if there is uncertainty as to tax writeoff. I understand that.

What I do not understand is why the public utilities commission, under those circumstances, could not allow in its rate decision for that tax writeoff, if IRS has taken a position adverse to the regulatory

agency, why that agency, then, would not adjust its own rate base to take into account that IRS decision.

Mr. DALENBERG. I assume that the commission—for instance, in our case, when we are through litigating with the IRS over our tax return, if we have to do that to establish what the Federal law is—in about 1983 will prospectively make a change. But the general regulatory law talks in terms of precluding retroactive correction. Maybe they should retroactively correct to increase rates going back, but I have not heard of many commissions who have found that palatable.

Mr. HUGHES. Is that not something which should be properly addressed to the ratemaking authority?

Mr. DALENBERG. Let us go back to your original question, if I may, and that is why is there irreparable injury. There is, and they cannot correct that. A simple analogy demonstrates irreparable injury best.

Assume you are buying a house, you bought it a few years ago, and you have a large mortgage on it. At the same time, you are spending your money on improvements and using every borrowable dollar you can for improvements. You have exhausted your borrowing capability to improve things. The bank walks in and says we are accelerating, you do not have 30 years to pay it off, you have to pay it now. But you have been using, in order to keep up with your current needs, as the telephone companies are, their maximum ability to finance. How do they finance that payment on the mortgage?

IRS in this situation is just the same as the bank that holds the mortgage on the house. You start out assuming you have gotten a long-time deferral, and they walk in one day and say because things were done wrong, you have to pay that lump sum now. You have to finance it some way.

Mr. HUGHES. Is there not a basic difference between the analogy you have suggested and a public utility? Actualy, it is the utility consumers, the users, who would be called upon to provide additional money, if it was determined you did not indeed have sufficient writeoff.

I do not think that is analogous to where a homeowner is called upon to pay the mortgage off in an accelerated fashion.

Mr. DALENBERG. The current consumer pays current expenses. The consumer is not normally called upon to invest, and we are talking about capital dollars, dollars that are devoted to the capital machinery that runs the utility. Those are the dollars that have to be replaced when the mortgage is called.

There is no question but that that consumer takes on a burden when that happens. You have to go out and borrow. It is going to be expensive. The interest factor on those dollars gets worked into the rate structure. Part of the irreparable injury is the timelag factor. But assuming no timelag, that consumer will pick up the additional cost, and you are correct to that extent.

Mr. HUGHES. I understand what you are saying, and I am sympathetic, but it seems to me the difficulty with your position is that there are a legion of cases as to dispute between IRS and taxpayers. If we permitted a declaratory judgment in all those instances we would have a lot of suits being brought for declaratory judgment. If there were no other remedy I could understand your argument, but it seems to me the public utilities commission would be the necessary agency to make the decision on disputes as to Federal law. If that option

were not available, I think I would be much more sympathetic to your position.

Mr. DALENBERG. Are you saying the public utilities commission determination of the utility's taxes should be binding on the Federal Government?

Mr. HUGHES. No, what I am saying is in setting rates, what you are primarily concerned with is if there is some question as to your ability to write a certain amonut off, which in effect would erode the dollars available to you for capital or otherwise. Then it would seem the public utilities commission would be the proper agency to restructure your rate.

Mr. DALENBERG. There has never been a case that I can think of where the Congress has delegated to the State regulatory commission this power of eligibility. It is common for the utility commissions to do as you have described, estimate what your tax liability is going to be, and that is not really what we are talking about. If it were a matter purely of the rates and what rate level the State commissions should be setting, we would not be here before you. Your problem is that that action triggers this Federal eligibility, which is subject, finally, to the ultimate word of the Federal court. There is no question but that the Federal courts will try to adhere to some form of uniformity in construction of that Federal law, which the State regulatory commissions cannot accomplish.

Mr. HUGHES. I understand, but in the final analysis, you have to be prepared for any eventuality, and that might include a decision by the Supreme Court, ultimately, if it gets that far, that indeed the IRS interpretation is the correct one, in which event you would have to make adjustments in any event. All you are attempting to do is to accelerate that decision.

My question is, why can the utility commission not provide at this time, when there is a dispute between IRS and the regulatory agency's decision, for whatever eventuality?

Mr. DALENBERG. I would think the utility commission that followed a careful method of ratemaking would undertake in some fashion to see to it that the utility would not be severely injured by this problem, but as demonstrated in California, that commission has not been interested in changing its methods to reduce the risk. That risk has current problems for the utility. That risk has the current problem of the ability to finance while the ever-growing liabilities increase.

As long as you have two independent sovereigns in our State, that State sovereign may very well sit back on its hind legs and say, we are right, they are wrong. It is that situation which this statute reaches out to correct. It is unique, and we think it is badly needed.

Mr. HUGHES. Thank you.

Mr. DANIELSON. The gentleman from Illinois, Mr. McClory.

Mr. MCCLORY. Thank you very much, Mr. Chairman.

As a consumer of electricity, telephone service, and all the other services provided by our great privately owned utilities, I want to come down very strong in behalf of the utilities. The service which our private enterprise utility services offer in contrast to the publicly owned services which we find in other countries of the world is tremendous. There is such sharp contrast that I think the American consumer really appreciates the capability of the services offered in this country.

When I think of some of the ordeals the utilities have gone through, I just fear for the future of the American way of life and recognize the problems the utilities are experiencing in their ratemaking procedures and in improving and expanding their capability. It is something which is horrendous to contend with.

I would judge what you are seeking here more than anything else is the certainty, a definitive statement with regard to what future tax liability is and the expenses the companies would experience, so that the expenses can be accurately considered in the ratemaking process.

Is the problem unique in California? I notice you refer to California and you say that the California commission failed to take into consideration the liabilities of the utility, which could be determined by the declaratory judgment procedure.

Mr. DALENBERG. I think the problem in this dimension is unique to California. I think California is the only State where it has gotten out of hand.

Problems to lesser extents have cropped up in other States. Maine has had problems, I think, North Carolina a couple of years ago. I think very likely, most of the regulatory commissions are looking on with some high degree of concern as to California and that there is a good deal of pressure on those commissions to keep rates low in this kind of environment we are in with inflation, and the problem is likely to be occurring in other States as the years go by.

Mr. MCCLORY. How about in Illinois? Are they more understanding?

Mr. DALENBERG. In Illinois, back in 1961, the Illinois Supreme Court made some very good law for the Illinois commission, and I do not think the Illinois commission has had any particular problems in this area since then.

Mr. MCCLORY. By the enactment of this piece of legislation, are we, in a sense, overriding a part of the policy, part of the ratemaking practice of the State of California or other State regulatory agencies? Not that I am against that.

Mr. DALENBERG. I do not think so. I think the legislation studiously avoids dictating any policy to a State. What it tries to do is dictate the certainty you refer to. The State is free to say it wants to adhere to the legislation or go on a contrary path. This would not change their options at all.

Mr. MCCLORY. You are not suggesting the California Public Utilities Commission would favor this legislation?

Mr. DALENBERG. I think they would favor the idea there should be some certainty. I am not sure they would wholeheartedly favor that, as they have opposed declaratory judgment relief in our particular problem. I think they have sought to avoid having that degree of certainty without a statute as such.

Mr. DANIELSON. We do have a representative of the California Public Utilities Commission with us this morning, and he will be available for questioning.

Mr. MCCLORY. Those are the only questions I have, Mr. Chairman.

Mr. DANIELSON. The gentleman from Maryland, Mr. Barnes.

Mr. BARNES. Mr. Dalenberg, how did you reconcile the injunctive relief which you seek with the Johnson Act?

Mr. DALENBERG. I do not think there is an inconsistency between the suggestion which I made, which as I indicated a moment ago I do not

view as indispensable for solving this kind of problem. I think declaratory relief is the key thing. Providing, as I mentioned in my testimony, the ability for the Federal court to hold the status quo while it grants declaratory judgment would not be inconsistent with any provision of the Johnson Act.

The normal court position would be that it may maintain a status quo so that its declaratory relief can have some meaning.

I seriously dobut with the availability of declaratory relief that would clarify the Federal law, that any responsible commission would simply charge ahead. I think a great deal of the California problem is that they do not believe the IRS but they would believe a court. That is why I say I do not think injunctive relief is the key to this at all.

Mr. BARNES. So you would be prepared to concede on that?

Mr. DALENBERG. If that is extremely troublesome, certainly.

Mr. BARNES. Several pages of your testimony relate to the situation in California and the situation your company finds itself in, and you have indicated in response to an earlier question from Mr. Moorhead that it is relatively unique, certainly in its dimensions it is unique.

How did you get into this mess?

The California Supreme Court has in a unanimous decision indicated its judgment as to how your company got into this mess. Perhaps you would want to comment on this. The supreme court said:

> . . . the unreasonable expense due to such calculation was due to an imprudent management decision.
>
> Although prior to the statutory change Pacific was free to change its method of accounting on its income tax returns but now may no longer do so, its inability to switch is due to its original imprudent determination to pay Federal income taxes on a straight line depreciation basis and its obstinacy after the 1968 commission decision in adhering to the imprudent determination.

Mr. DALENBERG. You are referring to a 1971 decision of the court.

Mr. BARNES. That is right.

Mr. DALENBERG. The court at that time was referring to the situation back in 1968. I think, was it not?

Mr. BARNES. That is correct.

Mr. DALENBERG. Well, now, I do not see that that has any particular relevance here, but I would be glad to comment on it.

In 1969 the Congress changed the eligibility requirements for utilities to use accelerated depreciation. The effect of that change was that a utility such as Pacific which had not used it before and had not used accelerated depreciation because it felt strongly that the flowthrough method of accounting was bad accounting under the 1969 law change, Pacific could not use accelerated depreciation for tax purposes unless normalization accounting is followed both by the utility and the ratemaking body.

Pacific can do nothing other than what it is doing currently. I do not think what the management may or may not have done in 1968 has any real bearing on the situation we find ourselves in, which relates to an order of the California Supreme Court which agrees that normalization accounting is correct for us, that it is distinctly in the interest, according to the commission, of both the ratepayer and the utility to maintain eligibility under the Federal tax law, and therefore that the normalization accounting for accelerated depreciation and ratable flowthrough for the investment tax credit should be followed.

The problem we are in now does not relate to the 1960's, it relates to the 1977 change in ratemaking method by the commission, a change

which the IRS on three separate occasions has advised will destroy the eligibility which the commission says is strongly in the interest, not only of ourselves, but of the ratemakers.

Mr. BARNES. It is implicit there is something improper as to loss of eligibility.

When Congress was considering this question, it had before it the option of making the requirement more strict, but instead made it an eligibility situation rather than a mandated situation with respct to the tax incentives, and noneligibility is not somehow improper, at least not in Congress' judgment, because a company not eligible for these benefits is not somehow acting improperly, or is it?

Mr. DALENBERG. With reference to the term "improper," it certainly is not improper for a State commission to say we do not want our State utilities to be eligible for this Federal tax benefit and go on and make rates recognizing that state of affairs. It is improper to say whether they are eligible but we will assume they are and make rates willy-nilly. It would not be improper for a State to say they do not want to participate in this.

It may be improper not to seek to be eligible. The rates are lower under normalization than they would be under straight-line depreciation, which one would have if you are not eligible for the rates ultimately. In the long run they are substantially lower under the normalization method.

Mr. BARNES. How are you collecting your rates?

Mr. DALENBERG. Under injunctive relief from the Ninth Circuit Court of Appeals which leaves in effect a normalization order, until a date in August when the decision would go in effect. Yesterday, I filed papers with the U.S. Supreme Court to prevent that.

Mr. BARNES. How do your books reflect your tax status and potential tax deficit?

Mr. DALENBERG. Our financial accounting shows that the likelihood of the loss of eligibility is probable and therefore that the taxes are going to be paid.

We maintain showings in our books both ways so that we can track the existence of the size of the problem. I think you will find our annual report, the financial accounting showings in the annual report. in our prospectus, et cetera, reflect the enormous tax liability we face.

Mr. DANIELSON. Mr. Kindness of Ohio.

Mr. KINDNESS. Mr. Dalenberg were you here to hear the testimony of Mr. Ferguson in behalf of the Justice Department?

Mr. DALENBERG. Yes; I was.

Mr. KINDNESS. Are you familiar with a memorandum for the United States as amicus curiae in Nos. 78-606 and 78-607 in the Supreme Court in which the Solicitor General indicated:

> But these are unusual cases. As matters now stand, the decision below and the Internal Revenue Service are on a collision course that threatens the financial stability of all regulated public utilities in California and potentially affects other similarly-situated companies. If, as we submit, the decision below is based on erroneous interpretations of the applicable federal tax law, a delay in establishing that fact with finality will result in the simultaneous subjection of the utilities to lower rates based upon the false assumption of eligibility for substantial tax benefits and the disallowance of those benefits. Thus, the resolution of the conflict between the decision below and the Internal Revenue Service cannot practicably await the outcome of the federal tax litigation with respect to the deficiencies that inevitably will ensue. A decision with such far-reaching impact upon a vital sector of the nation's economy calls for review by this Court.

Do you recall seeing that?

Mr. DALENBERG. Very clearly.

Mr. KINDNESS. I apologize I was unable to be here earlier, but I understand that amicus curiae memorandum was not mentioned in the testimony of the Department of Justice earlier. But I think it is very pertinent and I would solicit any comments you might have as to the position of the Department of Justice in those instances as compared to the kind of neutral position the Department seems to be taking at this point.

Is there any difference between the importance of resolving this conflict now, as compared to the time when this amicus curiae memorandum was filed?

Mr. DALENBERG. No; except that it has become more dangerous as time has passed.

Mr. KINDNESS. Mr. Chairman, I will submit perhaps the record of this hearing ought to contain a copy of the memorandum in behalf of the United States as amicus curiae in those cases.

Mr. DANIELSON. I fully concur. I would like to make this suggestion. I think each of us has been supplied with the data to which the gentleman from Ohio refers, and I will recommend that our counsel while we are home working in our districts, that they go through those items which will be of help, and put the whole thing in the record, including the items to which the gentleman has referred. Will that be acceptable?

Mr. KINDNESS. Certainly.

Mr. DANIELSON. Thank you, Mr. Kindness.

Thank you, Mr. Dalenberg.

We will be in touch with you and I will assume someone will be monitoring our progress in your behalf. So we can keep in touch. Is my assumption correct?

Mr. DALENBERG. It is.

[The Amicus Curiae memorandum and petition for Certiorari follows:]

Nos. 78-606 and 78-607

In the Supreme Court of the United States

OCTOBER TERM, 1978

PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA, ET AL.

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
PETITIONER

v.

THE PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA, ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

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Department of Justice
Washington, D.C. 20530

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MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

QUESTION PRESENTED

The United States will discuss the following question:

Whether the California Public Utilities Commission erred in holding that its ratemaking orders preserved petitioners' eligibility for the investment credit and accelerated depreciation for federal income tax purposes under Sections 46(f) and 167(*l*) of the Internal Revenue Code of 1954.

INTEREST OF THE UNITED STATES

In 1969 and 1971, Congress enacted Sections 167(*l*) and 46(f) of the Internal Revenue Code of 1954, respectively, which deal with the eligibility of regulated public utilities for accelerated depreciation and the investment credit. Section 167(*l*) provides that a regulated public utility that had not previously claimed the benefits of accelerated depreciation could not do so unless it used the "normalization method of accounting" for ratemaking purposes. The use of such a method of accounting insures that the benefits of the utility's depreciation deductions will be allocated equally between its present and future customers. Section 46(f) similarly places certain limits upon eligibility for the investment tax credit. With respect to petitioners, Section 46(f)(2) permits the credit only on the condition that they reflect that credit in their cost of service for ratemaking purposes no faster than ratably over the useful life of their property.

In these cases, the California Public Utilities Commission issued ratemaking orders based on methods of accounting that it concluded would "maintain the eligibility of the utilities to use accelerated depreciation and ITC [investment tax credit] and comply with the requirements of the Internal Revenue Code relating to [petitioners]" (J. App. B, 49A-50A).[1] However, the Internal Revenue Service has ruled that the Commission's assumption was erroneous and that methods of accounting it required would in fact destroy petitioners' eligibility because they do not provide for normalization (in the case of depreciation) or an allowable ratable reduction (in the case of the investment tax credit) (J. App. D, 95A-131A; J. App. E, 133A-142A).

As the official charged with the responsibility of administering and enforcing the federal income tax statute, the Secretary of the Treasury agrees with petitioners that the interpretation of the Internal Revenue Code by the California Public Utilities Commission, upheld by the court below, requires review by this Court at this time in order to put to rest uncertainty as to a fundamental issue potentially affecting the tax liabilities of all regulated public utilities. If the decision below is correct, petitioners would be subject to the rate adjustments ordered by the Commission but would be eligible for the benefits of accelerated depreciation and the investment credit

[1] "J. App." refers to the Joint Appendix filed on behalf of both petitioners.

that they have claimed. But as matters now stand, petitioners are simultaneously subject to the ratemaking orders of the Commission and the assertion of massive federal income tax deficiencies exceeding $1 billion in accordance with the Treasury's rulings. If this Court were to decline review and the Treasury's ruling position is ultimately sustained in a federal tax proceeding, petitioners would suffer the burden of lower rates (based on the assumption of eligibility for the federal tax benefits) and disallowance of those tax benefits. Moreover, if the California Public Utilities Commission's interpretation of Sections 167(*l*) and 46(f) remains unreviewed while the Treasury continues to adhere to its position, the decision below is likely to be followed by other state regulatory bodies to the detriment of similarly-situated public utilities. The United States believes that the continued existence of this conflict between the Treasury and the state regulatory commissions threatens to work an enormous hardship upon the public utilities sector of the economy and to disrupt the stability of the capital markets as affected utilities must undertake borrowings to meet these large-scale federal tax obligations.

STATEMENT

These state public utility ratemaking cases uniquely present legal questions that solely involve the proper interpretation of two federal tax statutes.

Section 167(*l*) of the Internal Revenue Code of 1954, which was enacted as part of the Tax Reform

Act of 1969, permits a regulated public utility to claim the benefits of accelerated depreciation if it had not previously done so on the condition that it use a "normalization method of accounting" for rate-making purposes. Section 46(f) of the Code, which was enacted in 1971 as part of the restoration of the investment credit, similarly conditions a utility's eligibility for the credit upon the computation of its cost of service for ratemaking purposes by ratably reducing such cost by the tax credit amortized over the useful lives of its assets. By requiring normalization of depreciation and ratable accounting of the investment tax credit, Congress sought to avoid the loss of federal revenues that would otherwise occur if these tax benefits were immediately "flowed through" to the current ratepayers thereby resulting in reduced rates and reduced taxable income. See H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 172 (1969); H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 26 (1971); S. Rep. No. 92-553, 92d Cong., 1st Sess. 39 (1971).

In these proceedings, the California Public Utilities Commission was acutely conscious of the need to preserve petitioners' eligibility for accelerated depreciation and the investment credit. It stated (J. App. B, 22A):

> Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their rate-

> payers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis.

The Commission thereupon took petitioners' accelerated depreciation into account pursuant to a method of accounting it characterized as the "averaged annual adjustment" (AAA method) (J. App. B, 25A). It "believe[d] [that its] method [was] direct, simple, and in full compliance with the applicable federal law" so that [e]ligibility [for accelerated depreciation] will be maintained * * *" (J. App. B, 27A). In taking the investment credit into account for ratemaking purposes, the Commission adopted a method that it believed "to encompass all the factors [it] desire[d]," which it characterized as "the annual adjustment" (2A method) (J. App. B, 30A).

Petitioners sought a continuation of the then-existing rates until such time as they could seek a ruling from the Internal Revenue Service as to whether the Commission's methods would preserve their eligibility for accelerated depreciation and the investment credit (J. App. B, 39A). Although the Commission acknowledged that "[w]e have here a

case of first impression under the tax laws" (J. App. B, 40A), it rejected petitioners' request for delay on the ground that "an advance ruling within a reasonable time [was] not probable" (*ibid.*). It therefore concluded that the AAA and 2A methods of accounting "maintain the eligibility of the utilities to use accelerated depreciation and ITC [investment tax credit] and comply with the requirements of the Internal Revenue Code relating to [petitioners]" (J. App. B, 49A-50A).

The Commission reached its decision by a 3-2 vote. Of the three members in the majority, two concurred noting that "[t]he *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be" (J. App. B, 70A; emphasis in original). The two dissenting members were of the view that the Commission should have allowed petitioners a reasonable period of time to obtain a ruling from the Internal Revenue Service. They concluded that it was "imprudent of the Commission not to exhaust available consultive procedures and thus safeguard the state against the catastrophic consequences of ineligibility" (J. App. B, 72A).

Less than three weeks after the Commission issued its order, petitioners sought rulings from the Internal Revenue Service as to their eligibility for accelerated depreciation and the investment credit under the AAA and 2A methods devised by the Commission. Nine and ten months later, the Internal Revenue

Service issued letter rulings to petitioners respectively concluding that the AAA method was not a normalization of accounting under Section 167(*l*) of the Internal Revenue Code (J. App. D, 95A-131A), and that the 2A method was inconsistent with the requirements of Section 46(f) of the Code (J. App. E, 133A-142A). Accordingly, the Service concluded that the Commission's order destroyed petitioners' eligibility for accelerated depreciation and the investment credit.

Upon reciept of the Internal Revenue Service's ruling with respect to accelerated depreciation, petitioners asked the Commission to join them in requesting the Supreme Court of California (where petitions for review had been filed) to remand the cases to the Commission in light of the Internal Revenue Service ruling. The Commission declined, stating that the ruling "adds nothing new to these proceedings" (78-607 Pet. 15).

The Supreme Court of California denied petitions for review.[2] One member of the court was of the opinion that the petition should have been granted (J. App. A, 1A-2A).[3]

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[2] Under California law, the California Supreme Court's order denying review was a decision on the merits. The jurisdiction of this Court is therefore properly invoked under 28 U.S.C. 1257(3). See *People* v. *Western Air Lines, Inc.*, 42 Cal.2d 621, 630, 268 P.2d 723, 728, appeal dismissed, 348 U.S. 859 (1954). See also *Napa Valley Electric Co.* v. *Railroad Commission*, 251 U.S. 366 (1920).

[3] The Internal Revenue Service's ruling with respect to petitioners' eligibility for the investment credit was issued on

DISCUSSION

These cases present federal tax questions of enormous potential fiscal significance to regulated public utilities that should be resolved by this Court.

1. In *FPC* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 459-461 (1973), this Court reviewed the background that led to the enactment of Section 441 of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 625, which added Section 167(*l*) to the Internal Revenue Code of 1954. Section 167, as originally enacted in 1954, permits a taxpayer to compute depreciation of its business assets either on a straight-line or accelerated basis. The straight-line method yields an equal annual depreciation allowance over the useful life of the asset. The accelerated or liberalized methods provide for depreciation allowances in the early years that are greater than the straight-line method but which steadily decrease over the useful life of the asset.

Federal income taxes are properly included as an expense by a regulated public utility in computing its cost of service for ratemaking purposes (see 411 U.S. at 460 n.2). As originally enacted in 1954, the Internal Revenue Code provided no rules governing the manner in which a public utility was to compute its federal tax expense for ratemaking purposes if it elected to use accelerated depreciation. Accordingly,

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July 27, 1978, two weeks after the California Supreme Court denied review of the Commission's orders in these cases (J. App. A, 1A-2A; J. App. E, 133A).

the regulatory commissions required utilities using accelerated depreciation for tax purposes to use the same method for calculating their cost of service and, thus, to "flow through" the resulting tax savings to their customers (*id.* at 460).

In 1969, Congress became concerned with the loss of tax revenues that resulted from the combined effect of accelerated depreciation (leading to higher tax deductions) and flow-through for fixing rates (leading to lower rates and therefore lower gross revenues). As a result, Congress added Section 167(*l*) to the Internal Revenue Code, which generally provides that utilities that had not previously used accelerated depreciation could not do so unless they used the "normalization method of accounting" for ratemaking purposes. Under the normalization method, a utility computes its cost of service as if it were using straight-line depreciation, and "must make adjustments to a reserve to reflect the deferral of taxes resulting from the use" on its tax return of an accelerated method of depreciation. Section 167(*l*)(3)(G), J. App. C, 82A-83A. In other words, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes is placed in a deferred tax reserve account. This method was designed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation and make the deferred taxes available to the utility for investment.

The statute is silent as to how the deferred tax reserve is to be treated for ratemaking purposes. Treasury Regulations, Section 1.167(*l*)-1(h)(6), J. App. C, 88A-93A, permits the reserve account to be excluded from the utility's base to which its rate of return is applied. The theory of this exclusion is that the amount of the deferred taxes is treated as an interest-free loan to the utility and that the utility is not entitled to a return on that part of its capital base that is not provided by its shareholders. However, Section 1.167(*l*)-1(h)(6)(i) of the Regulations is explicit as to the proper amount of the exclusion from the rate base. It provides that "a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(*l*) which is excluded from the base to which the taxpayer's rate of return is applied * * * exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking."

The Commission's AAA method of accounting runs afoul of this explicit prohibition of the Regulations. It does not limit the exclusion to the utility's deferred tax reserve in the test year, *i.e.*, the period used for computing the rate base and cost of service. To the contrary, the Commission's method provides for an exclusion from the rate base by the estimated average of the deferred tax reserve for the test year and the three succeeding years. Given the fact that peti-

tioners continue to make additions to their plant (see J. App. B, 58A-59A), the Commission's method unquestionably results in an exclusion that "exceeds the amount of [the] reserve for deferred taxes for the period used," *i.e.*, the test year. This is not a normalized method of accounting. See Treasury Regulations, Section 1.167(*l*)-1(h)(6)(iv), Ex. (1), J. App. C, 89A-90A. By hypothesizing a larger deferred tax reserve than in fact exists, the Commission has required a partial "flow through" of the tax deferral to the utilities' present customers in derogation of Congress' intent in enacting Section 167(*l*).

2. The Commission's 2A method of taking the investment credit into account also thwarts the congressional purpose of providing a tax incentive to modernize plants by prohibiting the pass-through of the credit to the utility's current ratepayers. Thus, Section 46(f) provides that no investment credit will be allowed with respect to any public utility property if (1) the utility's cost of service for ratemaking purposes is reduced by more than a ratable portion of the allowable credit over the useful life of the property or (2) the utility's rate base for ratemaking purposes is reduced by reason of any portion of the allowable credit (see J. App. C, 76A).

Here, the Commission's 2A method took a ratable portion of the investment credit into account in computing cost of service for the test year based upon projected capital additions. However, the Commission gave no recognition to the fact that if the utility has an increased credit based upon estimated capital addi-

tions for succeeding years, it necessarily also has increased depreciation expenses and an expanded rate base. By freezing petitioners' depreciation and rate base at test year levels but increasing the credit (and thereby reducing the cost of service) for succeeding years, the Commission has reduced the cost of service "by more than a ratable portion of the credit allowable" in contravention of Section 46(f)(2)(A). The result will be disallowance of petitioners' claimed investment tax credits.

3. In urging review of the decision below, we are not unmindful of the fact that this Court generally grants certiorari in federal tax cases only where there is a conflict of decisions. See, *e.g.*, opinion of Mr. Justice Stevens respecting the denial of the petition for certiorari in *Singleton* v. *Commissioner*, No. 78-78 (Oct. 30, 1978), slip op. 4. Here, the federal tax questions presented are concededly technical and have been addressed only by the decision below in a state ratemaking proceeding and by the Commissioner of Internal Revenue in private letter rulings to petitioners. Normally, these facts would call for further development of the questions by the federal courts prior to this Court's exercise of its discretionary review.

But these are unusual cases. As matters now stand, the decision below and the Internal Revenue Service are on a collision course that threatens the financial stability of all regulated public utilities in California and potentially affects other similarly-situated companies. If, as we submit, the decision below is based

on erroneous interpretations of the applicable federal tax law, a delay in establishing that fact with finality will result in the simultaneous subjection of the utilities to lower rates based upon the false assumption of eligibility for substantial tax benefits and the disallowance of those benefits. Thus, the resolution of the conflict between the decision below and the Internal Revenue Service cannot practicably await the outcome of the federal tax litigation with respect to the deficiencies that inevitably will ensue. A decision with such far-reaching impact upon a vital sector of the nation's economy calls for review by this Court.

CONCLUSION

The petitions for a writ of certiorari should be granted.

Respectfully submitted.

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Solicitor General

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Assistant to the Solicitor General

NOVEMBER 1978

No. 78-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said Public Utilities Commission, ET AL.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

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October 1978

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PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

Petitioner, The Pacific Telephone and Telegraph Company, respectfully prays that a writ of certiorari issue to review the judgment of the Supreme Court of California entered on July 13, 1978, upholding the decision of the California Public Utilities Commission entered on September 13, 1977.

OPINIONS BELOW

The final judgment of the California Supreme Court (App. A, p. 1A) is reported at 21 Cal. 3d, Official Advance Sheets, No. 21, minutes, p. 3 (1978). The judg-

ment was entered without opinion, one judge dissenting from the Court's refusal to issue a writ of review. The decision of the California Public Utilities Commission (App. B, pp. 3A-74A) is as yet unreported.

JURISDICTION

The judgment of the California Supreme Court was entered July 13, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3).

QUESTIONS PRESENTED

1. Did the California Public Utilities Commission violate the provisions of the Internal Revenue Code §§ 46(f) and 167(*l*), and therefore the Supremacy Clause of Article VI of the United States Constitution, by requiring petitioner to pass on to its customers federal tax benefits of accelerated depreciation and investment tax credits, when petitioner is forbidden by federal law to receive such tax benefits if it passes them on rather than having them available, as Congress contemplated, for capital investment?

2. Did the California Public Utilities Commission deprive petitioner of its property without due process of law in violation of the Fourteenth Amendment: (a) by reducing rates on the basis of outdated financial estimates when actual data more favorable to petitioner were before the Commission, in violation of this Court's ruling in *West Ohio Gas Co.* v. *Public Utilities Commission,* 294 U.S. 79 (1935); (b) by making rates on the assumption that petitioner was eligible for accel-

erated depreciation and the investment tax credit, when the Commission's ratemaking methods themselves destroyed that eligibility?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article VI and the Fourteenth Amendment to the Constitution; pertinent provisions of the Internal Revenue Code of 1954, 26 U.S.C. §§ 46(f), 167(a), 167(*l*), 167(m); and the Treasury Regulations thereunder, 26 C.F.R. §§ 1.167(*l*)-1(a)(1),-1(h)(1), (6), are reprinted in Appendix C, pp. 75A-93A.

STATEMENT

This case arises from a conflict between federal tax policy as enacted into law by Congress in 1969, 1971, and 1975, when it set conditions on the use of accelerated depreciation and the investment credit by regulated public utilities, and state ratemaking policy regarding those federal tax benefits, as ordered by the California Public Utilities Commission ("Commission") and the California Supreme Court.

Petitioner, The Pacific Telephone and Telegraph Company ("Pacific"), is a California corporation engaged in the business of rendering telephone service in the State of California. As such, its intrastate rates and services are subject to regulation by the Commission, pursuant to the California Public Utilities Code.

Under the Internal Revenue Code, Pacific cannot be eligible for the tax benefits of accelerated depreciation and the investment credit unless its rates are

established in a manner consistent with ratemaking standards prescribed under §§ 167(*l*) and 46(f).

The decision of the Commission, as upheld by the California Supreme Court, reduced Pacific's intrastate telephone rates by adopting new ratemaking methods with respect to these federal tax benefits.[1] California's ratemaking methods misinterpret the requirements for eligibility for those tax benefits. After studying the Commission's decision, the Internal Revenue Service has issued formal rulings that these tax benefits will not be available to Pacific if the Commission's decision is placed in effect. Thus, if the Commission's order becomes final, Pacific will face a federal tax liability in excess of one billion dollars.

A. Legislative Background

Congress first allowed the use of accelerated methods of depreciation for federal income tax purposes in 1954, when it enacted § 167(b) of the Internal Revenue Code. The effect of accelerated depreciation, as contrasted with straight-line depreciation, is to produce higher deductions and lower income taxes in the early years of an asset's life, and to produce lower deductions and, consequently, higher income taxes in later years. Accelerated depreciation thus acts to defer federal taxes from early years to later years, leaving

[1] The Commission decision also applies to General Telephone Company of California ("General"). General also intends to petition this Court for certiorari. General and Pacific have filed a separately bound Joint Appendix, referred to herein as "App."

funds with the taxpayer available for investment during the intervening period. This is what Congress intended: "The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion." H.R. Rep. No. 83-1337, 83d Cong., 2d Sess. 24 (1954).

As originally enacted, the 1954 Code contained no special provisions relating to the treatment of accelerated depreciation for regulated utilities. In the absence of explicit federal limitations on regulatory agencies, the stated Congressional intent of stimulating the economy by fostering capital formation was partially thwarted in ensuing years. Since federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the tax deferral resulting from accelerated depreciation as a reduction in cost of service, and therefore lowered rates. In this way, the agencies immediately passed through to customers the amount of the current tax deferral. This practice, known as "flow-through" ratemaking, prevented the accumulation and investment of capital that Congress had intended when it enacted the 1954 Code. By reducing the utility's income the practice also reduced the amount of federal taxes to be paid.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, § 167 was amended as part of the Tax Reform Act of 1969.[2]

[2] Tax Reform Act of 1969, Pub. L. No. 91-172, § 441(a), 83 Stat. 625 (1969). *See Federal Power Comm'n* v. *Memphis Light, Gas*

Under newly-enacted § 167(*l*), a utility such as Pacific which had not previously used accelerated depreciation for federal tax purposes could thereafter use accelerated depreciation *only* (1) if the utility used the "normalization" method of accounting in its books of account *and* (2) if the regulatory agency used the normalization method in setting rates.[3]

Under normalization as prescribed by the Code and Regulations, (1) a utility's tax expense for ratemaking purposes must be computed as though "normal" (*i.e.*, straight-line) depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (*i.e.*, the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service.[4]

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and Water Div., 411 U.S. 458, 461 (1973); H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-134 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-176 (1969).

[3] Normalization accounting for deferred taxes is required for the financial reports of non-regulated businesses under generally accepted accounting principles. A.P.B. Opinion No. 11 (December 1967).

[4] I.R.C. § 167(*l*)(3)(G); Treas. Reg. § 1.167(*l*)-1(h)(1), (6) (App. C, pp. 82A, 86A, 88A). Essentially, the same normalization requirements govern Pacific's eligibility to depreciate its property using shorter lives under the asset depreciation range system and the class life system. *See* I.R.C. § 167(m); Treas. Reg. §§ 1.167(a)-

By allowing utilities such as Pacific to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: First, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital, and second, to avoid the additional loss of federal tax revenues that results when flow-through ratemaking is imposed.[5]

Two years after enacting § 167(*l*), Congress adopted a new investment tax credit, also designed to provide capital to stimulate modernization and expansion.[6] The investment credit is a direct dollar-for-dollar offset against taxes. It is earned in the year certain types of depreciable property are first placed in service. As with accelerated depreciation, Congress made the availability of the credit to public utilities such as Pacific conditional on strict adherence by regulatory agencies to ratemaking standards prescribed in the Internal

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11(b)(6), 1.167(a)-12(a)(4)(iii). For purposes of this petition, reference to accelerated depreciation includes these other depreciation systems as well.

[5] The federal government's tax revenue loss from flow-through ratemaking results first, from the utilities' use of accelerated depreciation itself, and second, from the reduction in the utilities' taxable income because of lower revenues under flow-through ratemaking. It was the revenue loss attributable to the latter factor that Congress found unacceptable. *See* H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 132 (1969).

[6] Revenue Act of 1971, Pub. L. 92-178, § 105(c), 85 Stat. 503. *See* H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 23-26 (1971). The 1971 Act established a 4 percent investment credit for public utility property used to furnish telephone service; the level of the credit was changed to 10 percent as part of the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301(a), 89 Stat. 26.

Revenue Code. By enacting what is now § 46(f),[7] Congress intended to achieve a result "essentially similar" to the normalization rules relating to accelerated depreciation.[8]

B. Proceedings Below

Pacific did not use accelerated depreciation in computing its federal income tax until after the passage of the Tax Reform Act of 1969 and thus can be eligible only if its rates are made using normalization. In 1970, the Commission held it would thereafter set Pacific's rates under normalization, stating that "it would now be futile to consider the relative merits of flow-through and normalization" *Re Pacific Tel. & Tel. Co.*, 71 Cal. P.U.C. 590, 594 (1970). The Supreme Court of California, however, annulled this order, suggesting that the Commission invent a "fictitious factor" and thereby "strike a balance between [the] two extremes" of flow-through and normalization. *City and County of San Francisco* v. *Public Utilities Commission*, 6 Cal. 3d 119, 130, 490 P.2d 798, 804 (1971).

In 1973, a new rate proceeding was initiated and in 1974 the Commission granted a rate increase. The Commission again concluded that only strict adherence to the ratemaking requirements of the Internal Revenue Code would preserve eligibility for the federal tax

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[7] This provision was originally enacted as § 46(e) in 1971, but was redesignated as § 46(f) under the Tax Reduction Act of 1975.

[8] H.R. Rep. No. 92-533, 92d Cong. 1st Sess. 25 (1971); S. Rep. No. 92-437, 92d Cong., 1st Sess. 38 (1971).

very tax benefits it was ordered to pass on to its customers.[11] The Commission also rejected a recommendation by the Administrative Law Judge in his proposed report that a 180-day period be allowed before the order was placed in effect so rulings from the Internal Revenue Service could be obtained.[12]

Pacific proceeded promptly to submit ruling applications to the Internal Revenue Service to determine eligibility. Pacific requested the Commission to participate before the Internal Revenue Service so that its position would be fully stated, but the Commission (two members dissenting) refused.[13]

On June 8 and July 27, 1978, the Internal Revenue Service issued rulings that, if the Commission's decision is placed in effect, Pacific will forfeit its eligibility for both accelerated depreciation (App. D, pp. 95A-115A) and the investment credit (App. E, pp. 133A-142A). Immediately after the issuance of the first ruling, Pacific requested the Commission to reconsider its decision in light of the position of the Internal Revenue Service. The Commission refused.[14]

Pacific had petitioned the California Supreme Court for review before the Internal Revenue Service rulings

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[11] *E.g.*, Ex. 7; Post-hearing Brief, pp. 5-47; Application for Rehearing, pp. 10-21. Pacific also raised below the Constitutional arguments here asserted. E.g., Ex. 7, pp. 24-25; Prehearing Memorandum on Refund Plans, pp. 4-7; Post-hearing brief, pp. 48-74; Application for Rehearing, pp. 17-28.

[12] Proposed Report, January 19, 1977, pp. 38-39, 42.

[13] Cal. P.U.C., Decision No. 88215 (December 6, 1977).

[14] Cal. P.U.C., Decision No. 88972 (June 14, 1978).

were issued.[15] The California Supreme Court denied Pacific's petition for review on July 13, 1978.[16] Under California law, the California Supreme Court's action constitutes an affirmance on the merits.[17] The Commission has granted a stay of its decision while review is being sought in this Court.

REASONS FOR GRANTING THE WRIT

I

The California Decision Is Directly At Odds With The Plain Meaning And Purpose Of The Federal Tax Laws, With The Treasury Regulations Implementing Those Laws, With The Position Of The Internal Revenue Service And, Therefore, With The Supremacy Clause Of Article VI

In the area of federal taxation, as in other areas of primary federal competence, the States are obliged by the Constitution to abide by national law. *Art. VI of*

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[15] Pacific urged that the Commission's decision conflicted with the eligibility requirements provided under the Internal Revenue Code, conflicted with Article VI of the United States Constitution, and denied due process in violation of the Fourteenth Amendment. Petition for Writ of Review in the California Supreme Court, pp. 5-6, 11-71; Reply Brief of Pacific in the California Supreme Court, pp. 4-33.

[16] Pacific had informed the California Supreme Court that rulings were being sought from the IRS and requested, *inter alia*, that the Court defer its decision until after the rulings were issued. The IRS ruling on accelerated depreciation, which was issued on June 8, 1978, was submitted to the California Supreme Court on June 9, 1978. The IRS ruling relating to the investment credit was issued on July 27, 1978, after the California Supreme Court denied review.

[17] *People* v. *Western Air Lines, Inc.*, 42 Cal. 2d 621, 630, 268 P.2d 723, 728, *appeal dismissed*, 348 U.S. 859 (1954).

the Constitution. In this instance, California has misinterpreted federal statutes thereby frustrating the basic Congressional purposes. Intervention by this Court is necessary to preserve federal policy and to ensure compliance with federal standards by California and other States when they interpret the same law.

The federal laws involved here do not compel a state commission to authorize a public utility to take accelerated depreciation or investment credit. The federal laws do, however, impose conditions on eligibility. If eligibility is to be preserved, the commission must allow the utility to retain a specified portion of the current tax deferrals or savings for investment purposes and must not deplete the tax benefits by reductions of the utility's rates.[18] The purpose of the federal laws was to assist the economy by stimulating investment while maintaining the level of federal tax collections,[19]

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[18] In *Memphis Light, Gas & Water Div.* v. *Federal Power Comm'n*, 462 F.2d 853, 856-60 (D.C. Cir.), *cert. denied on this issue*, 409 U.S. 941 (1972), the Court of Appeals for the District of Columbia Circuit ruled, in a related context, that the Tax Reform Act of 1969 deprived a regulatory agency of the power to set a utility's rates by imputing accelerated depreciation with flow-through. Relying on clear statements of congressional purpose, the Court held that unless the regulatory agency was willing to place the utility on straight-line depreciation for tax purposes and set rates accordingly, it was required to follow the normalization treatment of accelerated depreciation for ratemaking purposes.

[19] *See, e.g.*, S. Rep. No. 92-437, 92d Cong., 1st Sess. 35-41 (1971); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171 (1969); H.R. Rep. No. 83-1337, 83d Cong., 2d Sess. 24 (1954).

and not to provide short-run reductions in consumer costs.[20]

Starting in 1970, the Commission assured Pacific that it would be eligible for accelerated depreciation.[21] Pacific has filed its tax returns claiming the benefits and now finds its eligibility retroactively jeopardized at least back to 1974. The Commission has claimed to satisfy the federal conditions in determining Pacific's rates. Having made this undertaking to comply with federal law, the Commission—and the California Supreme Court adopting its decision—are bound by the terms of that law. The Supremacy Clause demands no less. "[A] State is without power by reason of the Supremacy Clause to provide the conditions on which the Federal Government will effectuate its policies. Whether the federal policy is a wise one is for the Congress and the Chief Executive to determine." *United States* v. *Georgia Public Service Commission*, 371 U.S. 285, 293 (1963).

A decision such as the Commission's in this case reduces current federal tax collections contrary to Congressional policy, and the economic stimulation resulting from the capital formation Congress sought is

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[20] If rates are maintained under normalization, in the long run they will be lower than under flow-through accounting. Tr. 889; 1973 Tr. 573-574, 647-648, 2157; Ex. 27.

[21] Decision No. 77984, 71 Cal. P.U.C. 590 (1970), *reversed, City and County of San Francisco* v. *Public Utils. Comm'n*, 6 Cal. 3d 119, 490 P.2d 798 (1971); Decision No. 83162, 77 Cal. P.U.C. 117 (1974), *reversed in part, City of Los Angeles* v. *Public Utils. Comm'n*, 15 Cal. 3d 680, 542 P.2d 1371 (1975).

frustrated, first by the impact of the partial flow-through of the tax benefits and ultimately by ineligibility. The effect of lost eligibility is the imputation of the tax benefits for ratemaking with partial flow-through since 1974.[22] These results create a serious "obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines* v. *Davidowitz*, 312 U.S. 52, 67 (1941).[23]

A. Accelerated Depreciation.

Pacific can only be eligible to use accelerated methods of depreciation for federal tax purposes if its rates are made using normalization. To explain how the California AAA method destroys that eligibility it is necessary to understand normalization ratemaking.

The utility's rates are set to permit it sufficient revenue to cover (a) its itemized expenses, plus (b) a rea-

[22] While we focus primarily on the AAA and 2A, the decision also directly imposed rate reductions based upon imputed accelerated depreciation with flow-through as to certain pre-1970 property, even though Pacific was entitled to straight line depreciation for such property by § 167(*l*)(1). *See Federal Power Comm'n* v. *Memphis Light, Gas & Water Div.*, 411 U.S. 458, 467 (1973), where this Court stated: "a utility using straight-line depreciation with respect to its pre-1970 property could not switch to accelerated depreciation, nor could a utility be required to switch to flow-through with respect to pre-1970 property." This alone created $43.5 million in refunds and a $5.5 million ongoing rate reduction (App. B, pp. 31A-32A).

[23] *See* S. Rep. No. 91-552, *supra* at 173-174; Staff of Joint Comm. on Internal Revenue Taxation, 91st Cong., 2d Sess., General Explanation of the Tax Reform Act of 1969 at 152 (Comm. Print 1970); *cf. Memphis Light, Gas & Water Div.* v. *Federal Power Comm'n*, 462 F.2d 853 (D.C. Cir. 1972), *cert. denied on this issue*, 409 U.S. 941 (1972).

sonable return on investment (*i.e.*, the rate of return times the rate base). Federal income tax is one of the itemized expenses. To meet the normalization requirements, federal tax expense is computed using straight-line depreciation. Then, to determine the taxes deferred, that same tax expense is recomputed using accelerated depreciation. The difference between the two tax computations is the amount of taxes deferred that year and this amount is placed in a reserve for deferred taxes.[24]

The normalization rules provide that the balance in the reserve for deferred taxes may be used to reduce the rate base.[25] Thus the current period's deferred taxes appear first, as part of the itemized tax expense and second, as the most recent addition to the balance in the reserve which is used to reduce rate base. To keep this synchronized and prevent flow-through, the Regulations limit the deduction from rate base to "the reserve for deferred taxes for the period used in determining the tax expense in computing cost of service".[26]

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[24] I.R.C. § 167(*l*)(3)(G); Treas. Reg. § 1.167(*l*)-1(h)(1), (2).

[25] Treas. Reg. §§ 1.167(*l*)-1(a), 1.167(*l*)-1(h)(6). Congress delegated special authority for the Secretary to promulgate regulations to carry out the "purposes" of Section 167(*l*). I.R.C. § 167(*l*)(5). This delegation is in addition to the Secretary's general authority to issue interpretive regulations. I.R.C. § 7805.

[26] Treas. Reg. § 1.167(*l*)-1(h)(6). If the exclusion from the rate base is so limited, the resulting decrease in revenues merely prevents the utility from earning a return on the portion of its operating assets financed with deferred taxes. If an excessive amount is excluded from the rate base through overstating the deferred tax reserve, however, the effect is to flow through a portion of the deferred taxes, thereby defeating normalization.

A part of the ratemaking process which is unrelated to the computation of either the itemized tax expense or deferred tax reserve but which is relevant to understanding the Commission's decision is the "gross up" process. If, for example, the revenue from existing rates covers only the itemized expenses, then multiplying the rate of return times the rate base would give the amount of *net* revenue increase needed to achieve the authorized return. To compute the gross revenue needed to achieve that net revenue, the procedure in California has been to multiply the net revenue needed by a "net-to-gross multiplier". This multiplier has components to account for the effects of uncollectables and state and federal taxes.[27]

The California AAA reduced the rate base for the test year by the average of the deferred tax reserve for the test year plus the succeeding three years.[28] The reserve balances in each succeeding year increased, so that the four-year average far exceeded the reserve for the test year. This violated Treas. Reg. § 1.167(*l*)-1(h)(6). Indeed, Example (1) in that Regulation explicitly shows the California AAA method to be inconsistent with the normalization requirements.[29]

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[27] *See* Table 1 to the decision, notes 5 and 6 (App. B, pp. 56A-57A).

[28] The decision does not state why it chose a four-year period. Had it elected to use a longer period for the average it would accomplish 100% flow-through.

[29] Treas. Reg. § 1.167(*l*)-1(h)(6)(iv), Example 1. In that example, rate base, tax expense and cost of service are determined for a single test year, as is true under AAA. The example holds that,

The Commission asserts that it has met the requirements of the Regulations by also computing tax expense in the cost of service for the same four-year period (App. B, p. 27A). But this it has not done. Its computations are set out in Table 1 of the decision (App. B, pp. 56A-57A) and show the Commission merely computed the net revenue reduction associated with the larger deduction from rate base and then converted that to a gross revenue reduction by applying the net-to-gross multiplier. It did not compute the itemized tax expense for the three later years.

Thus the AAA fails. The itemized tax expense for the three years after the test year is ignored, and the additional deferred taxes included in the four-year average reserve have not been included in the itemized tax expense for the test year. Thus, the reserve balance used does not relate to the "period used in determining . . . tax expense in computing cost of service." The net-to-gross multiplier does not enter into the computation of the tax deferral and its use cannot form a basis for eligibility. Indeed if the gross up process is all that is needed to preserve eligibility, every method of excessively reducing rate base would pass muster and the statute and regulations would be a dead letter.

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if the amount of deferred taxes excluded from rate base exceeds the balance in the deferred tax reserve at the end of the test year, as is true under AAA, the utility is not following the normalization method of accounting (App. C, p. 89A).

B. Investment Credit.

It is equally clear that the Commission's 2A method will result in loss of eligibility for the investment credit. Section 46(f)(2) of the Internal Revenue Code places precise limits on the amount of the credit which may be flowed through to consumers. Under that section, eligibility for the credit can be maintained only if the credit is flowed through as a reduction in cost of service no more rapidly than ratably over the period for which depreciation expense is recognized on the property that produced the credit. In addition, to assure that there is not excessive flow-through, section 46(f)(2) provides that the rate base may not be reduced by reason of any portion of the credit.

The 2A method automatically reduces rates at the beginning of each year after the test year. For each year after the test year, the method reduces Pacific's test-year cost of service by a ratable portion of the estimated amount of investment credit to be received for the subsequent year. However, the method freezes Pacific's depreciation expense and rate base (as well as other figures) at test-year levels, notwithstanding Pacific's growth in each year after the test year. Thus, each annual reduction in cost of service exceeds the limits of section 46(f)(2) because cost of service is reduced not only by a ratable portion of the new investment credit but also by exclusion of the additional depreciation expense on the property which produced that credit. Moreover, in each year that 2A applies, there is an impermissible reduction in rate base, because

the additional investment which produced the credit is entirely excluded from the rate base.[30]

Although the Commission's decision professes to preserve eligibility for the federal tax benefits, the Commission openly admits that its ratemaking methods are a compromise between established normalization principles and full flow-through (App. B, p. 27A, citing 6 Cal. 3d 119, 130-31 [490 P.2d 798, 804]). But the specific ratemaking standards prescribed by the Internal Revenue Code do not permit any compromise. Nor can it be said that the Commission has narrowly missed preserving eligibility; its misinterpretation of the federal standards is egregious. Under the California interpretation, $55 million of the tax benefits are ordered to be flowed through each year, contrary to Congressional policy and the Code provisions.

In sum, the Commission has based its decision on an erroneous application of federal laws and the decision itself will have direct and far-reaching effects under those laws. The frustration of federal policy and irreparable harm flowing from this error can be pre-

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[30] For example, assume that in a year following a test year Pacific acquired property for $100,000,000, with a useful life of 20 years, producing an investment credit of $10,000,000 and additional annual depreciation expense of $5,000,000. Under 2A, cost of service for the year of acquisition would be reduced not only by $500,000 ($10,000,000 ÷ 20) by reason of ratable amortization of the investment credit, but also by the exclusion from cost of service of the additional depreciation expense of $5,000,000. Moreover, no portion of the $100,000,000 investment in property which produced the credit would be included in the rate base.

vented only by a decision of this Court and a remand of the case so that rates may be set in conformance with the eligibility requirements of the federal laws.

II

The Case Presents Important Issues As To The Proper Relationship Between The Federal Tax Laws And State Regulatory Policy. If The California Decision Is Left Standing, Federal Policy Will Be Frustrated And The Consequences To The Petitioner, To Other Public Utilities, And To Consumers Throughout The Country Will Be Devastating And Irreparable

Even when viewed in its narrowest perspective, the effect on Pacific and its ratepayers, this case is of unusual importance. Pacific faces what is probably the largest back tax liability in history. If the Commission's rates are placed into effect and Pacific's eligibility under §§ 46(f) and 167(*l*) of the Code is destroyed, Pacific will owe federal taxes, excluding interest, of at least one billion dollars.[21]

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[21] The accelerated depreciation tax deferrals and the tax credits attributable to the intrastate portion of Pacific's business are:

	Reserve for Deferred Taxes	Investment Tax Credit	Annual Total
1974	$ 91,017,000	$ 24,901,000	$115,918,000
1975	108,494,000	62,157,000	170,651,000
1976	117,880,000	75,014,000	192,894,000
1977	129,800,000	88,200,000	218,000,000
1978 (est.)	141,800,000	93,800,000	235,600,000
1979 (est.)	139,900,000	113,100,000	253,000,000
Total	$728,891,000	$457,172,000	$1,186,063,000

The combined total, exclusive of interest, is the amount of the tax deficiency if the decision below is inconsistent with eligibility. (Figures are from Ex. 10A through 1976; the actual figure recorded is shown for 1977; 1978-1979 figures are estimated.)

The effect on Pacific and the people that depend upon its service will be devastating. The amounts attributable to the accelerated depreciation tax deferral and the investment credits have been invested in plant and equipment, as Congress intended, and are not available to pay the back tax liability. The uncontradicted evidence below established that borrowing enough money to finance that liability, Pacific's only alternative, would exhaust Pacific's ability to borrow (Ex. 9, pp. 26-32). The ability to sell common equity has already been impaired, for Pacific's stock sells at only about two-thirds of book value.[32] No common equity has been sold since 1973. Standard and Poor's rating of Pacific's debt securities has fallen precipitously since 1973, resulting in dramatically increased cost of debt and limiting Pacific's ability to sustain its capital investment program.

In examining the consequences if Pacific's eligibility were destroyed, the uncontradicted evidence established that Pacific would then be unable to meet the demand for telephone service (Ex. 9, pp. 31-32; Ex. 11, pp. 4-18); many orders for new or changed service could not be met and within a year 275,000 customers would be waiting for service (Ex. 11, pp. 11-12); existing facilities would be clogged and many local and long distance calls would be delayed or go uncompleted (Ex. 9, pp. 26-34; Ex. 11); and Pacific would be forced to lay off at least 12,500 employees, creating a ripple effect caus-

[32] At the time of trial book value was $20.36 per share [it is now over $22.00]. The stock is traded on the New York and Pacific Exchanges. Ex. 9, p. 14.

ing layoffs by suppliers (Ex. 11, p. 10). The destructive effect on telephone service would unquestionably injure the entire California economy.

The Commission understood this and quite correctly found that loss of eligibility would "not only create service problems . . . but would create staggering financial problems." This would ultimately result in "staggering rate increases" (App. B, p. 22A). Indeed, an appreciation of the problems led two of the three majority Commissioners to state, in a separate concurrence, that "the *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be" (App. B, p. 70A).

Petitioner is caught in the middle. The State of California holds that its action preserves eligibility under the federal tax statutes; the federal agency charged with administering those statutes has ruled that it does not. Eligibility is not within petitioner's control, for it is dependent upon the manner in which the Commission sets the rates.

If the decision below becomes final and the rates which it mandates are placed into effect, the situation will be irreversible. The Commission does not appear to have the authority to correct its ratemaking retroactively even if that were permitted under the Code.[23]

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[23] *See City of Los Angeles* v. *Public Utils. Comm'n*, 15 Cal. 3d 680, 705-707, 542 P.2d 1371, 1388-1389 (1975); *Pacific Tel. & Tel. Co.* v. *Public Utils. Comm'n*, 62 Cal. 2d 634, 401 P.2d 353 (1965); I.R.C. § 46(f)(4); Treas. Reg. § 1.167(*l*)-1(h)(4).

The Internal Revenue Service audit process lags several years behind the filing of the tax returns. Pacific's returns for 1974 and later years have not, as yet, been audited. If the decision below becomes final, the Internal Revenue Service will pursue the audit process that will ultimately lead to assertion of the tax deficiencies. By the time that process is concluded and, as Pacific believes will be the case, eligibility is determined to have been destroyed, there will be no means of undoing the harm and by then the tax liability will have grown to two billion dollars.

The potential impact of the present case reaches far beyond the parties involved. Other utilities in California are already being subjected to orders with similar effect,[34] and other state ratemaking agencies are following the present proceedings closely, for some have only reluctantly met the eligibility conditions set by Congress for accelerated depreciation and the investment credit.[35] Since the effect of the decision below is to reduce rates in the short run, regulatory agencies throughout the country will find themselves under pressure to take similar actions if the Commission's

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[34] *E.g., Sierra Pacific Power Co.*, Decision No. 88337 (Cal. P.U.C. January 17, 1978).

[35] *See, e.g., Re South Central Bell Tel. Co.*, 15 P.U.R. 4th 87, 117-119 (La. Pub. Serv. Comm'n 1976), *remanded on other grounds*, 352 So. 2d 964 (La. Sup. Ct. 1977); *Re Michigan Bell Tel. Co.*, 3 P.U.R. 4th 1, 15 (Mich. Pub. Serv. Comm'n 1973). At the time the Tax Reform Act of 1969 was adopted about half the regulatory agencies required flow-through accounting. *See* S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-172.

decision is left standing. Not only would such actions seriously erode federal policy, but they would occasion unnecessary and grave jeopardy to utilities and give rise to a period of widespread financial uncertainty and consuming litigation. Ultimately, the effects would be borne by consumers throughout the country. Unless this Court resolves the issues presented now, while there is still time to do so effectively, the program Congress established as an aid to investment by utilities and thus as an aid to the economy will become a vehicle of destruction.

III

The Judgment Below Conflicts With The Decision Of This Court In *West Ohio Gas Co. v. Public Utilities Commission*, 294 U.S. 79 (1935), Is Destructive Of Petitioner's Financial Integrity And Deprives Petitioner Of Its Property Without Due Process Of Law In Violation Of The Fourteenth Amendment

It is the essence of this Court's ruling in *West Ohio Gas Co.* v. *Public Utilities Commission*, 294 U.S. 79 (1935), that due process demands that judgment be based on facts rather than hypotheses or fictions, at least where, as here, the facts were before the decision maker at the time of the decision. *West Ohio* was violated by the decision below in two ways: first, with regard to a question that was on all fours with *West Ohio*, and second, by a ruling that is plainly inconsistent with its rationale.

A. The Violation of *West Ohio*.

In *West Ohio*, this Court held it to be a violation of due process for a regulatory agency to rely on previous

estimates in setting rates and ordering refunds when actual financial results demonstrated that the actual earnings were below the return the agency had found reasonable. The Court held that the refusal of the Ohio Commission to be guided by the actual results before it was an "arbitrary restriction in contravention of the Fourteenth Amendment and of 'the rudiments of fair play.'" 294 U.S. at 81. Mr. Justice Cardozo, for a unanimous Court, reasoned:

> The earnings of the later years were exhibited in the record and told their own tale as to the possibilities of profit. To shut one's eyes to them altogether, to exclude them from the reckoning, is as much arbitrary action as to build a schedule upon guesswork with evidence available. There are times, to be sure, when resort to prophecy becomes inevitable in default of methods more precise. At such times 'an honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances' [citations omitted], is the only organon at hand, and hence the only one to be employed in order to make the hearing fair. But prophecy, however, honest, is generally a poor substitute for experience. * * * We have said of an attempt by a utility to give prophecy the first place and experience the second that 'elaborate calculations which are at war with realities are of no avail' [citations omitted]. We say the same of a like attempt by officers of government prescribing rates to be effective in years when experience has spoken. A forecast gives us one rate. A survey gives another. To prefer the forecast to the survey is an arbitrary judgment. [294 U.S. at 81-82.]

The constitutional principle established in *West Ohio*

has been regularly followed in most state and federal courts.[36]

In 1974 the Commission set the reasonable rate of return for Petitioner at 8.85% per year[37] and established new rates. In 1976 the Commission granted another rate increase, because Petitioner had not achieved that return under the 1974 rates. By the time the Commission decided this special tax proceeding, the actual experience under those rates was known, was before the Commission, and was not disputed.[38] Pacific earned only 7.57% in 1974, 7.6% in 1975 and 8.1% in 1976.[39] The shortfall in earnings actually ex-

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[36] *E.g., Williams* v. *Washington Metropolitan Area Transit Comm'n*, 415 F.2d 922, 945-46 (D.C. Cir. 1968), *cert. denied sub nom. D.C. Transit Sys., Inc.* v. *Williams*, 393 U.S. 1081 (1969); *Intermountain Gas Co.* v. *Idaho Pub. Utils. Comm'n*, 98 Idaho 718, 722, 571 P.2d 1119, 1123 (1977); *New York Tel. Co.* v. *Public Serv. Comm'n*, 29 N.Y.2d 164, 169-170, 272 N.E.2d 554, 556 (1971); *General Tel. Co.* v. *Michigan Pub. Serv. Comm'n*, 341 Mich. 620, 67 N.W.2d 882 (1954). *But see South Central Bell Tel. Co.* v. *Louisiana Pub. Serv. Comm'n*, 355 So. 2d 253 (La. Sup. Ct.), *cert. denied*, —— U.S. ——, 98 S.Ct. 3103, 57 L.Ed.2d 1142 (1978) (White, J., and Powell, J., dissenting); *Mountain States Tel. & Tel. Co.* v. *Public Utils. Comm'n*, 180 Colo. 74, 81, 502 P.2d 945, 948 (1972).

[37] This was reduced on November 2, 1976 to 8.843%. Cal. P.U.C. Decision No. 86593.

[38] Ex. 9, p. 8; Ex. 10, Part 1. The failure of the existing rates to permit earning the authorized rate of return was again brought to the Commission's attention in Pacific's motion for rehearing (Ex. B to App. for Reh.).

[39] The rate of return figures cited are based upon the Commission's required ratemaking adjustments. The actual financial data (also in evidence and undisputed) is far worse; by a series of "adjustments" that are not the subject of this appeal, the Commission excluded large segments of the rate base and expense. For

perienced was huge: $123 million in 1974; $126 million in 1975; and $79 million in 1976. This was the actual situation before applying the rate reductions ordered by the Commission in this case. The refunds ordered here are $19.5 million for 1974; $61.3 million for 1975; and $57.9 million for 1976. (Tables 1, 3, and 5 of the decision, App. B. pp. 56A, 60A, 64A.) Had the Commission applied its ratemaking adjustments to the actual financial data for those years, the rates could not have been reduced. In the decision below, the Commission nevertheless ignored the shortfall revealed by the actual financial results, ordered the rates set in 1974 and 1976 reduced and ordered refunds reflecting that reduction back to 1974.

We do not argue here that the insufficient rates of past years must be retroactively raised in this proceeding to eliminate the actual shortfall experienced, for California law does not guarantee earning the return authorized. But where the rates in effect actually produced earnings far below the authorized return, the State cannot, consistent with due process, force those inadequate rates even lower.

B. The Decision Has A Destructive Impact On Pacific's Financial Integrity And Thereby Violates The Fourteenth Amendment.

In addition to ignoring the realities of the past, the Commission took no account of the effect of its action

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financial reporting the actual return figures were 7.2% for 1974, 7.35% for 1975 and 7.78% for 1976. (All figures relate to the intrastate business only.)

on Pacific's present or future financial integrity. By making rates on the assumption that Pacific is eligible for the federal tax benefits when in fact the ratemaking methods employed themselves destroy that eligibility, the Commission has simply confiscated a large portion of the earnings Pacific should receive.

The Commission's AAA method immediately denies any return on a large amount of investor-supplied capital.[40] In addition, the rate reductions and the effect of retroactive ineligibility for the tax benefits will force the actual rate of return two percentage points or more below that found reasonable by the Commission and California Court.[41]

The effect of the loss of eligibility for the tax benefits is utterly destructive of Pacific's financial integrity and will severely handicap, if not destroy, its ability to attract capital. The enormous risk has already had an adverse effect on Pacific's bond rating. The Commission itself found that the loss of eligibility would result in "the deterioration in financial position . . ." and would "create staggering financial problems . . ." (App. B, pp. 21A-22A).

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[40] For example, in the most recent test year the AAA excluded $556 million from rate base when the reserve for the test year was only $374 million. Thus, $182 million of investor capital was denied any return, even if eligibility is assumed.

[41] For past years, recognizing the full rate base and tax expense the actual returns are reduced to about 6.94% in 1974, 6.42% in 1975 and 6.79% in 1976, well below the 8.85% the Commission held reasonable. The return on the equity portion of the capital is forced below the cost of long term debt sold during the period. Ex. 10, Tr. 928.

This action by California directly contravenes the limitations placed upon state regulatory authority by the Fourteenth Amendment. In *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *Bluefield Waterworks & Improvement Co.* v. *Public Service Commission*, 262 U.S. 679, 693 (1923), this Court held that the reasonable return safeguarded by the Fourteenth Amendment is one "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital" (320 U.S. at 603). In *Permian Basin Rate Cases*, 390 U.S. 747, 792 (1968), this Court held that an important function of review is to "determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." The impact of the decision below in reducing the rates and risking a billion dollar back tax liability is to destroy investor confidence. Clearly, this regulatory action fails to meet the Constitutional standard. The Commission's own findings on the consequences of the loss of eligibility concede the confiscatory effect.

Regulatory action that is blind to such jeopardy is an abuse of state power. In *New England Tel. & Tel. Co.* v. *Public Utilities Commission*, —— Me. ——, —— A.2d —— (1978),[42] the Maine Supreme Court reversed

[42] The decision is reported in abridged form in [1974 *et seq.*] Util. L. Rep. (CCH) (State volume) ¶ 22,596.

action by the Maine Commission that had reduced rates in a manner that almost certainly would have destroyed eligibility for accelerated depreciation. The Maine Supreme Court held that merely placing the utility "in jeopardy of losing its ability to take accelerated depreciation for federal income tax purposes" was an "unreasonable exercise of power and abuse of discretion" (—— A.2d at ——, [1974 et seq.] Util. L. Rep. (CCH) (State volume) ¶ 22,596.03). Although the Maine decision was rendered under state law, its reasoning is equally applicable under the due process clause.

This Court has held that "rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the [utility] in our economic system remains strong." *Federal Power Commission* v. *Memphis Light, Gas & Water Div.*, 411 U.S. 458, 474 (1973). If left standing, the decision below is destructive of both interests.

Mr. DANIELSON. Our next witness is General Telephone Co. of California, represented by Albert M. Hart.

Mr. Hart has supplied us with his statement, which will be received in the record in its entirety. You may proceed at will.

[The information follows:]

SUMMARY OF STATEMENT OF ALBERT M. HART, VICE PRESIDENT AND GENERAL COUNSEL, GENERAL TELEPHONE CO. OF CALIFORNIA

Congress has provided that accelerated depreciation and the investment credit will not be availiable to public utilities if these tax benefits are flowed-through to current ratepayers instead of being used for capital investmeut.

If the Internal Revenue Service and the regulatory commission disagree whether proposed regulatory accounting will cause ioss of eligibility, no forum exists for prompt resolution of this dispute. Under existing rules final resolution could take 10–15 years after the first year affected.

If the courts ultimately sustain the IRS, the tax benefits will have been irretrievably lost. Billions of dollars may be involved.

In comparable cases (exempt organizaions, pension trusts, municipal bonds, and payments going abroad) Congress has provided for declaratory judgments.

Declaratory judgments on controversies between regulatory commissions and the IRS on tax aspects of accelerated depreciation and the investment credit will be in the best interests of ratepayer, investor, the public utilities, the regulatory body, and the Internal Revenue Service.

Only Congress can resolve this dilemma and action should be taken now.

STATEMENT OF ALBERT M. HART, VICE PRESIDENT AND GENERAL COUNSEL, GENERAL TELEPHONE CO. OF CALIFORNIA

My name is Albert M. Hart. I appreciate very much the opportunity to appear before this committee today. In my capacity as Vice President and General Counsel of General Telephone Company of California, I have participated for more than a decade in the controvery in California over whether part of the benefits from accelerated depreciation and the investment tax credit can be immediately passed through to current ratepayers instead of being used for capital investment as Congress intended. Unfortunately, that controversy has now descended to the point where the tax benefit may be lost completely and not be availiable for either purpose. Thus, I have an immediate personal and Company interest to present today. However, I am sure that our situation will arise elsewhere and that our experience can provide a useful factual foundation for a desirable extension of declaratory judgment jurisdiction.

LEGISLATIVE BACKGROUND

Both accelerated depreciation and the investment tax credit are tax incentives designed by Congress to encourage capital investment. Utilities, and the telepbone companies in particuiar, are among the most capital-intensive industries in the country. However, the investment incentive provided by these two programs would be lost to utilities if the tax benefits were immediately flowed through to ratepayers in the form of rate reductions.

Thus, in the case of public utilities (with some historic exceptions), Congress has specified as a condition of eligibility that the tax savings from accelerated depreciation be "normalized," (i.e., set up as a reserve rather than be used to reduce rates) (IRC Section 167(l)) and that the investment tax credit not be flowed through faster than ratably (IRC Section 46(f)).

CALIFORNIA SITUATION

In the case of the two major California telepbone companies, the California Supreme Court has forced the California Public Utilities Commission to adopt accounting regulations which the Internal Revenue Service has ruled do not meet the standards required for eligibiiity. The California Supreme Court and the United States Supreme Court, despite the urging of the Solicitor General of tbe United States, declined to revlew this decision of the Public Utiiities Commission. Within the last two weeks the U.S. Court of Appeals for the Ninth Circuit has affirmed a District Court denial of a further stay.

If the Internal Revenue Service ruling is ultimately sustained, additional taxes for the two telephone companies affected through the end of 1978 would amount to $1.2 billion, and would increase at a rate of $350 million per year until the controversy is resolved.

Under the normal pattern for resolving tax questions by litigation, no case may be brought until after the Internal Revenue Service has audited tax returns and the taxpayer has either taken the deficiency to the Tax Court or paid the tax and sued for refund in a District Court or the Court of Claims, a process which takes several years. If the final decision supports the IRS, it would not be possible to take any step to avoid the tax loss for any period prior to that decision.

IRS RULINGS

Normally, when taxpayers face large tax liabilities arising from a course of action, they seek advance rulings from the Internal Revenue Service and plan their future course of action based on the rulings of the Internal Revenue Service.

In this case, the telephone companies made timely application for rulings and the Internal Revenue Service ruled that, if the decision of the California Public Utilities Commission is implemented, eligibility for both accelerated depreciation and investment tax credit will be lost. Obviously, if the choice were theirs, the telephone companies would abandon rate accounting that could cost them over a billion dollars in unnecessary taxes.

The problem is that the California Public Utilities Commission does not agree with the ruling of the Internal Revenue Service and insists that the telephone companies proceed. There is no available forum for prompt resolution of this disagreement to avoid the staggering tax liability if the Commission is wrong.

NEED FOR RELIEF

In the recent Ninth Circuit litigation the United States filed a brief as amicus curiae which demonstrates the need for legislation. Although the United States agreed with the telephone companies that the Public Utilities Commission decision will cause loss of eligibility for accelerated depreciation and investment tax credit, the United States argued that it was inappropriate for that issue to be resolved at the present time. As summarized in the brief (p. 9) and set forth in greater detail (pp. 13–19), its position is:

". . . it must be noted that the present proceeding is not an appropriate one for the final resolution of the tax questions presented by the rate order here. Congress long ago determined that tax questions should not be considered ripe for such final resolution outside of the context of a deficiency or refund action. These time-honored principles preclude any final resolution of the tax questions here in the context of the present suit. Rather, such a final resolution must await the time when the Commissioner makes an adverse determination as to eligibility, adjusts their tax liabilities on the basis of that determination and the utilities perfect their right to bring a deficiency or refund suit attacking the adjustments."

Thus, only Congress can provide legislation making clear the right of all parties to a definitive decision on this tax question without the years of delay normally involved in tax litigation.

THE PRESENT PROPOSAL

H.R. 229 meets this problem head-on by providing that the normal prohibitions against declaratory judgment tax cases do no apply "with respect to the rate-making or accounting provisions of Section 46(f) [not 146(f) as printed], 167(l) or 167(m) of the Internal Revenue Code." This is an appropriately narrow description limited to the rate case where an interpretation of these provisions of the Internal Revenue Code is crucial to a rate determination.

Congress has previously made exceptions to allow declaratory judgments in such areas as qualification of pension plans (I.R.C. section 7476), qualification of charitable organizations (I.R.C. section 7428), transfer of property abroad (I.R.C. section 7477), and exemption of municipal bonds (I.R.C. section 7478). In each case, taxpayers were able to show that a definitive tax determination was needed before reasonable men could proceed. The same showing has been made by the utilities here.

H.R. 229 is fully consistent with the views expressed by Deputy Assistant Secretary of the Treasury for Tax Analysis Emil M. Sunley before the Oversight Subcommittee of the Committee on Ways and Means on March 28, 1979; tax rules are not very well equipped to handle controversy. The basic problem

"On the other hand, as recent events in California have shown, the current

is that two different parties, the utility and the regulator, have a say in determining the facts on which the tax subsidies are based. One process—ratemaking—exists to handle the relationship between the regulator and the utility. A second process—tax administration—exists to handle the relationship between the utility and the IRS. The two processes are independent, and as a result, a problem in one cannot as yet be handled easily in the other.

"In view of recent events, we are currently exploring both with regulators and utilities whether a separate tax proceeding can be devised to resolve quickly any questions involving sections 46(f) and 167(l). We hope to know soon whether a satisfactory procedure can be developed."

CONCLUSION

We strongly urge that H.R. 229 be enacted.

TESTIMONY OF ALBERT M. HART, VICE PRESIDENT AND GENERAL COUNSEL, GENERAL TELEPHONE CO. OF CALIFORNIA

Mr. HART. I hope I will not be repetitive of Mr. Dalenberg, who fielded a lot of very penetrating questions and I am sure gave the committee some important insight into this problem.

Mr. DANIELSON. I thank you very much for your comment and your perception. We do not want to cut you off on anything you think may be of help to us. But I do apreciate your recognizing that Mr. Dalenberg really covered the field quite well.

Mr. HART. Maybe I can, by recounting our experience in this area, add a little more insight, which we think demonstrates the need for this legislation.

We have been litigating almost continually within the commission, within the State courts, within the Federal court system for around 8 years, this particular issue, without a resolution of the eligibility question. That really is the nub of the case. We have not been able to determine who is right: the commission, which says the manner in which they have set our rates leaves us eligible, or the IRS, which says if your rates indeed become final on that basis you will become ineligible.

If we become ineligible we lose the tax benefits back to the year 1970. The investment credits, the entire reserve for accelerated depreciation is wiped out clear back to the year 1970. The quantification of those dollars appears in our prepaid statement, which while not of the magnitude of Pacific's, are not inconsequential. We are looking at a figure of about $300 million if those taxes should become due. We are caught between the two regulatory agencies, neither of which is about to surrender its prerogatives to the other. The IRS is not going to accept the public utilities commission's construction of the Federal tax statutes and the public utilities commission has not seen fit to accept the IRS' rulings. We obtained IRS rulings, as Pacific did, which said without qualification that if the commission's methods went into effect we would become ineligible for the tax benefits.

Today there is really no expeditious way to resolve this kind of conflict, to break the impasse betwen the IRS and the public utilities commission. Of course, you must recognize between those two sovereigns, the telephone company is in the middle. We have tried to work it from both angles without success at all.

The remedies that are available in my opinion are not remedies. The first is the procedure which Mr. Ferguson referred to, wait until there is an assessment by the IRS, then we go to the mat with the IRS

in the Federal court years later. If the commission's order becomes effective, it is too late regardless of what the determination is down the road.

The second method, which we have dutifully pursued, is proceeding through the State courts to the U.S. Supreme Court. The problem with that is that the procedures are discretionary review procedures. We took the commission's decision to the California Supreme Court and we were denied a hearnig. You are all familiar with the certiorari procedure. In California it is sometimes called review. Review was denied. We took that denial to the U.S. Supreme Court on a petition for a writ of certiorari and certiorari was denied, neither court ever having to come to grips with the question of whether tax eligibility was considered.

Now the unfortunate thing is that the denial of review by the California Supreme Court becomes a decision on the merits whether or not they even consider the question of eligibility. So, it is really a nondecision on that question, which in effect puts us out of court. We tried to get into the lower Federal courts, the district court; we took that court's refusal to issue an injunction to the ninth circuit court, and the answer was we cannot take this case under consideration because the California Supreme Court has already ruled and the matter is res judicata. So as I say, the remedies do not cover the substantive issue which is the question of eligibility for the tax benefits. That is the dilemma we find ourselves in, and it cries for a legislative solution. That is why we strongly urge adoption of the bill.

I will not take any more of your time. If you have questions, I will be glad to answer.

Mr. DANIELSON. Your position does not differ with that of Mr. Dalenberg. You simply expanded on that.

Mr. Hughes?

Mr. HUGHES. No questions.

Mr. DANIELSON. Mr. McClory?

Mr. MCCLORY. No questions.

Mr. DANIELSON. The gentleman from Maryland?

Mr. BARNES. Just one question, Mr. Chairman.

You say H.R. 3939 is consistent with the view of Mr. Sunley of the Treasury Department.

Are you telling the subcommittee that the Treasury Department supports this bill?

Mr. HART. No, I was quoting from a statement Mr. Sunley made before the oversight committee which was at that time considering the investment credit bill. In a statement related to the fine-tuning of that legislation, he pointed out this dilemma did exist and was one which needed some resolution. I did not intend to take his statement out of context, but it is directly in line with the point I am trying to make as to the need for this legislation.

Mr. BARNES. Thank you.

Mr. DANIELSON. The gentleman from Ohio, Mr. Kindness?

Mr. KINDNESS. No questions.

Mr. DANIELSON. The gentleman from Kentucky, Mr. Mazzoli?

Mr. MAZZOLI. I have questions, but since I was late, these questions may have been asked.

Is this situation peculiar to the State of California?

Mr. HART. So far as I am aware. Mr. Dalenberg referred to the State of Maine, but the Maine Supreme Court overturned the decision.

We can all understand the other States are watching very carefully to see how it is going to be resolved.

Before the 1969 act there were some 19 States on flowthrough. That was one of the reasons for the 1969 act being cast the way it was, because of the threat of a tremendous loss of revenues to the Federal Government by all the States going to this flowthrough concept.

Mr. MAZZOLI. When Congress passed the law to deal with accelerated depreciation and investment credit, et cetera, did it contemplate setting up a very careful or a new procedure here for dealing with the utility? Is there any legislative history for Congress being aware that this would pose special problems to industries in the regulated monoply area?

Mr. HART. There is extensive legislative history, but Congress intent was that the utilities not be treated any differently from any other industry, that they have internally generated funds available for capital improvement. Congress was afraid they would lose that because of the State regulatory agencies falling into the flowthrough pattern, and the legislation of 1969 was supposed to bring that to a stop and it did, to my knowledge, in every State.

Mr. DANIELSON. When we passed the bill, did we provide certain exclusions or exemptions from the inclusion in accelerated depreciation to certain industries, if they had done certain things or failed to do certain other things?

Mr. HART. There were three qualifying criteria in the bill. One was if you were going to be able to take accelerated depreciation you had to normalize.

The second one was for companies which had been on flowthrough prior to a magic date, which I think was something like July of 1968, flowthrough could continue, but the utility could switch with the consent of the regulatory agency. There were different percentages of investment credit allowed initially, but those have been made uniform over the years.

To answer your question as to whether Congress intended the utilities to be treated differently from any other industry in the country, I would have to answer, "No."

Mr. DANIELSON. Mr. McClory?

Mr. MCCLORY. Are you not fearful that by providing for this additional action, the declaratory judgment action, to which there may be added provisions regarding intervention by others, that there might be interventions by public interest groups or all kinds of other parties? Might you not just be involving yourselves in another bit of litigation which will be protracted and be expensive, including an appeal from the declaratory judgment proceedings? Do you have any fear of that?

Mr. HART. There is always a possibility, but the declaratory judgment would provide a vehicle to deal with the eligibility question, and compress the time required under present procedures, even with other parties involved.

Mr. MCCLORY. It is my understanding that if your accounting procedures were adopted or accepted by the California commission, the need for this legislation would not exist. Is that correct?

Mr. HART. In the case before the commission we recommended setting rates on a methodology which we felt was consistent with the

statutes and the applicable Treasury regulations relating to them. The commission adopted a hybrid system. The IRS said the hybrid system will not retain our eligibility. The commission says it will. And that is the question to which we have received no solutions as yet.

Mr. McCLORY. Thank you.

Mr. DANIELSON. Thank you very much for your help, Mr. Hart. I might announce before calling the next witness, the question of what was the position of the Treasury Department was raised. During the hearing this morning I have received a letter from the Treasury Department signed by Donald C. Lubick, Assistant Secretary of Tax Policy. I have not had time to read it, but it will be made available to all concerned.

[The information follows:]

DEPARTMENT OF THE TREASURY,
ASSISTANT SECRETARY,
Washington, D.C., July 30, 1979.

Hon. GEORGE E. DANIELSON,
Chairman, Subcommittee on Administrative and Law and Governmental Relations, House Judiciary Committee, Washington, D.C.

DEAR CHAIRMAN DANIELSON: You have requested the Treasury's views on H.R. 229. The proposed legislation represents an important inroad on a fundamentally sound policy barring declaratory relief in Federal tax cases. Because we believe firmly in that policy we have reservations about this bill. Nevertheless the ban on declaratory relief in the tax area is not absolute, and we have in the past acknowledged instances in which departures appeared appropriate. Since we do not at this time have sufficient information upon which to decide whether we are now confronted with another such instance, we hope that hearings on the bill will elicit answers to several questions upon which our final position is likely to depend. We would be interested particularly in the views of the affected regulatory commissions and governmental units. Indeed an exchange of views between those groups and the utilities could prove most helpful to us in formulating our own position.

1. SUMMARY OF H.R. 229

H.R. 229 would permit a declaratory judgment action to be commenced in any Federal court on the issue of whether a rate-making order complies with the normalization rules contained in sections 46(f), 167(1) and 167(m) of the Internal Revenue Code. Jurisdiction would be based on the denial by the Internal Revenue Service of a requested ruling, or on the passage of 180 days after the ruling had been requested. A proceeding could be commenced by either a public utility or by the rate-making body. The utility, the rate-making body and the Treasury would be necessary parties to the action. Although H.R. 229 does not now so provide, we understand that AT&T feels a modification is necessary, explicitly authorizing the Federal court in the declaratory judgment action to stay the rate-making proceeding.

2. BACKGROUND

Sections 46(f), 167(l) and 167(m) of the Internal Revenue Code deny a public utility the benefits of the investment tax credit, accelerated depreciation and use of class lives if these benefits are "flowed through" to customers in the form of lower current rates, instead of being retained for their intended purpose of increasing capital investment. To be entitled to the benefits, the utility is required to "normalize" its depreciation and investment credit by accounting for them as capital acquisition and financing subsidies, the benefits of which reduce the cost of service over the life of the subsidized assets, rather than as a reduction in the current year's cost of service. The difference may be illustrated simply with reference to the investment tax credit. Although somewhat different mechanically, the same principle applies to accelerated depreciation.

If a utility were to invest $100 in machinery, it would potentially be entitled to a $10 investment tax credit. This credit, however, although administered through the tax system, is in fact a capital subsidy. Consequently the Internal Revenue Code mandates that the credit be treated as a $10 reduction in the cost

of the machinery, which will result in lower depreciation charges and a lower cost of private capital, reflected in lower cost of service to customers over the entire life of the machinery. The credit is denied if, in setting rates, the utility accounts for the credit as a reduction in current year's tax liability, to be flowed-through directly to customers in the form of lower cost of current service.

The problem to which H.R. 229 is addressed arises when there is a question as to whether a rate-making order complies with the requirements of the Internal Revenue Code. At present, a utility may seek to have the question resolved by a ruling from the IRS. If the ruling is adverse, however, unless the regulatory body amends the rate order a utility must await examination of its tax return before a final determination of its eligibility can he obtained. The practical effect of this process is that the utility may be unahle to obtain final resolution of the Federal tax question until many years after the rate-making order has been in effect. Utilities claim that, should the IRS prevail, they can be faced with an enormous additional tax liability which cannot, in many cases, be passed on to customers whose rates had been reduced on the assumption that the tax benefits were available. The economic impact of paying such deficiencies, it is contended, will have a severe adverse impact on the utility's ability to raise capital, and, indeed, to provide services. The proposed legislation is intended to enable either the utility or the regulatory body to obtain an early determination of the compliance of the rate-making order with the Federal tax requirements for the investment credit and accelerated depreciation. Other Federal tax issues, which may arise in a rate-making proceeding are unaffected by the bill.

3. Issues

There are several issues upon which we feel the need for further clarification before we are able to reach a definite conclusion about the desirability of the proposed legislation.

A. CONSISTENCY WITH THE POLICY AGAINST DECLARATORY JUDGMENTS IN FEDERAL TAX CASES

There is a long standing Congressional policy, thoroughly endorsed by the Treasury Department, barring declaratory judgments in Federal tax cases. Because widespread use of declaratory judgment procedures would have a substantial adverse impact on tax administration, Congress has fostered the orderly and prompt determination and collection of Federal taxes hy insulating the administration of the Federal tax laws from judicial intervention. Although there have been, in recent years, several exceptions made to the policy against declaratory judgments, each appears to have been a response to the difficulty or impossibility otherwise of ever obtaining judicial review of an adverse IRS determination. Thns, without declaratory relief, a charitahle organization denied a favorahle ruling on its tax exempt status would effectively be precinded from ohtaining public contrihutions, even though the IRS never assessed a deficiency which could be challenged in court. Similarly, a denial of a favorable ruling on the tax exempt status of municipal bonds was effectively immune from judicial review because the adverse ruling prevented the sale of the bonds. Since favorable tax treatment certain transfers to foreign corporations is made expressly dependent upon an IRS ruling that the purpose of the transfer was not tax avoidance, failure to obtain the ruling was again fatal, regardless of how a court might independently have assessed the taxpayer's purpose. Finally, an employee who claimed that his exclusion from coverage under a qualified pension plan violated Federal tax requirements had no way of ohtaining judicial review of an IRS ruling that he was properly excluded.

The only situation in which declaratory relief has been provided although judicial review would nonetheless have been available appears to be that of retirement plans which the IRS has ruled fail to meet Federal tax requirements. Since it is likely that deductions claimed for contributions to snch plans would have been disallowed hy the IRS, judicial review would have heen available. Confirmation of the IRS position, however, would have a suhstantial adverse impact not only on the employer claiming the deduction, hut on its employees as well. It may be significant, therefore, that this lone departure from the pattern of limiting declaratory relief to situations in which judicial review would otherwise have heen unavailable was enacted as part of ERISA, a comprehensive Federal statutory plan for providing retirement security for millions of employees. The well-being of utility customers and investors has, hy contrast, traditionally been a matter for state authorities.

In the situation to which H.R. 229 is addressed, the utilities clearly will be able ultimately to obtain judicial review of an adverse IRS determination. They claim that such review will be delayed substantially, at enormous cost to them if the IRS is ultimately sustained. In this respect, however, their position may not be distinguishable from that of any other taxpayer which, if it chooses to challenge in the courts what it regards as a questionable IRS interpretation, may be forced to run substantial risks. Perhaps the utility's position can be distinguished by the fact that it can be compelled by a rate-making body to take this risk against its will. In numerous other situations, however, an erroneous Federal tax interpretation by a governmental body could subject a class of taxpayers to considerable risk of economic injury. If each such situation is to be regarded as an appropriate occasion for such relief, the effective administration of the tax laws could be impaired substantially.

B. DAMAGE CAUSED THE UTILITY BY AN ADVERSE TAX DETERMINATION

The utilities have asserted that failure to obain an early resolution of the tax issue could, if the IRS were ultimately sustained, result in a crippling tax deficiency. We are uncertain, however, about the precise consequences to the utility, because it is unclear how a regulatory commission would respond to a deficiency of the magnitude envisioned. Whatever the regulatory response, it is likely that ultimately the cost will have to be borne by customers in the form of higher rates. In the interim, however, payment of the deficiency might require resort to the capital markets, which could produce an immediate disruption whose magnitude would increase directly with any increase in the deficiency caused by delay in final adjudication of the tax controversy. Investors who had to sell could suffer real losses. Yet the regulatory commissions, which are charged with the responsibility of assuring both a fair rate to customers and a fair return to investors, have not thus far urged the need for any change in the normal procedures for resolving tax controversies. Before taking a position on the need for declaratory relief, we would like further elaboration of the economic impact and of the views of the affected regulatory bodies.

C. WILL THE PROPOSED BILL ACCOMPLISH ITS OBJECTIVES?

The avowed purpose of the bill is to enable a speedier resolution of the tax issues, binding on all parties. We have reservations both about the binding effect of the determination on the regulatory body and about the extent to which final resolution will be accelerated.

Even though the proposed declaratory judgment procedure would authoritatively determine the Federal tax consequences, the effect on the regulatory body of an adverse determination is unclear. Although it could modify the rate order to remedy the tax infirmities, it would be under no obligation to do so. The Federal declaratory judgment proceeding may then have served simply to provide substantiation for the utility in a potential state court due process claim. Alternatively, the regulatory body could make some minor change in its order, and again seek a declaratory judgment. This procedure could then be repeated until a favorable determination was obtained. In addition to straining judicial resources, such a process would probably place an unbearable strain on normalization requirements meant to be largely self-enforcing.

Our second reservation about whether the proposed bill would accomplish its objective concerns the likelihood of substantial acceleration. A declaratory judgment proceeding can commence no sooner than the issuance of a rate order. In fact the proceeding will not be able to commence until sometime thereafter, because the IRS must be given time to consider the tax consequences of the order. Under the bill, an action may be brought only after the IRS has either denied a ruling request or failed to act upon a request within 180 days. Two-hundred and seventy days would probably be preferable. A far more significant delay, however, may be unavoidable, depending upon when the rate order is regarded as ripe for declaratory review. If the order is reviewable when proposed by the regulatory body, the Federal court will be passing upon the tax consequences under a rate order which could very well be changed upon appeal through normal state channels. As in the case of the regulatory commission itself modifying its order, we would then be presented with the problem of multiple declaratory judgment proceedings.

If, on the other hand, the commencement of the declaratory judgment proceeding must await the outcome of the state appeals process, substantial time

will already have elapsed since the order originally was issued. There must then be added the time needed for trial and appeal of the declaratory judgment action itself, which could be substantial, particularly if, as the IRS believes it should, the trial is to be a de novo proceeding rather than simply a review of the administrative record compiled in the ruling request. It is, therefore, not clear that the tax questions will be resolved much sooner in the proposed declaratory judgment proceeding than they would have been in the normal audit and appeal process.

D. CONSISTENCY WITH THE JOHNSON ACT

The Johnson Act (28 U.S.C. section 1342), which embodies a Congressional policy of non-intervention by Federal courts in State rate-making proceedings, was enacted to compel resort to state court review. Although explicitly applicable only to diversity jurisdiction and to Federal constitutional questions, the same policy interdicting Federal court intervention may similarly apply to Federal tax issues arising in rate-making proceedings. Presumably, if a state court is competent to decide Federal constitutional claims, it can also decide whether the rate order satisfies Federal tax requirements. Although a state court is unable to bind the IRS to its interpretation of the Federal tax question, we are unclear that a state court's mistake about a Federal tax result is sufficiently different from other possible errors to warrant a departure from the underlying policy of abstention.

Compatibility with the Johnson Act may depend upon the answers to several further questions. If, as the utilities appear to feel, the effectiveness of declaratory relief is dependent upon the ability of the Federal court to grant a stay of the state rate-making proceeding pending the resolution of the Federal tax issue, we could encounter precisely the Federal interference in state proceedings which the Johnson Act was meant to prohibit. This would be particularly so if the stay covered the entire rate order, and not only its treatment of the tax items covered by H.R. 229. Moreover, if the case or controversy requirement of the Constitution and of the proposed statute is satisfied only if the rate-making order has assumed, contrary to the IRS view, that the tax benefits are available, the Federal court will have to ascertain the tax assumptions embodied in the rate order. If they are not clear on the face of the order itself, the Federal court may be required to conduct the very kind of in-depth review of the rate-making proceeding which the Johnson Act policy proscribes.

E. OTHER QUESTIONS

H.R. 229 raises several additional questions, some of which are of direct concern to Treasury. The bill now provides that the utility, the rate-making body and the Secretary of the Treasury shall be parties to the action. It is likely that affected municipalities, leading advocates of flow-through, and perhaps others, would also wish to participate. The implications of such participation must be considered from the viewpoint of time, scope of review and tax administration.

H.R. 229 would amend section 2201 of title 28 of the United States Code, and add a new section 2202. Since section 2201, while authorizing declaratory relief, does not confer jurisdiction on a court which would not otherwise be a proper forum, the proposed amendments appear to restrict the declaratory judgment proceeding to the district courts. In each other situation in which a declaratory judgment is authorized in a Federal tax matter, jurisdiction is granted to the Tax Court. Indeed, only on the question of qualification as a charitable organization, where concurrent jurisdiction is granted the Court of Claims and the District Court for the District of Columbia, is jurisdiction extended to any other court. In view of the expertise of the Tax Court in Federal tax matters, we are not convinced that it is appropriate in this case to limit jurisdiction to the district courts.

With the exception of California and now, we understand, Maine, most jurisdictions appear willing to adopt rate-making accounting rules which comply with the IRS's interpretation of the statutory requirements. In view of the enormous political pressure for flow-through, we are apprehensive that the existence of a declaratory judgment procedure would encourage these jurisdictions to test the limits of the tax requirements, with a consequent proliferation of litigation in what, California aside, has heretofore been a controversy-free area.

Finally, it is unclear whether the bill would be prospective only, or would apply to the pending controversy between California and the telephone companies. We

understand that the audit of AT&T may be nearing completion, in which case the normal review procedures which will be available are preferable to declaratory relief. Apart from the current controversy there appears to be little impetus for a declaratory judgment procedure.

We hope that the testimony before the committee will address the questions we have raised. When we have heard that testimony, we would appreciate the opportunity to present to the committee our views on the bill.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary (Tax Policy).

Mr. DANIELSON. Our next witness will be Mr. Mark Chandler, who is representing the California Public Utilities Commission.

Please come forward, Mr. Chandler. You have presented a statement, as I recall, so it, too, will be received in the record unless there is objection. You are free to proceed at liberty.

TESTIMONY OF MARK CHANDLER, CALIFORNIA PUBLIC UTILITIES COMMISSION

SUMMARY OF STATEMENT OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION ON DECLARATORY JUDGMENTS IN UTILITY TAX CASES

1. California shares the desire to provide an early and binding determination of utility tax benefit eligibility.

2. The advantages of such a determination are:

Certainty over the eligibility effect of alternative ratemaking procedures will increase regulatory flexibility.

Certainty over eligibility will reduce damaging consequences to companies and customers that may arise under present law.

3. California has six central reservations with respect to the current legislative proposal, H.R. 229, and AT&T amendments:

The legislation is not clearly limited to the tax implications of alternative accounting treatments.

The legislation may inadvertently provide a mechanism for seeking federal relief above and beyond the declaratory judgment.

Ratepayer representatives should be necessary parties to any declaratory judgment suit.

Any party to a ratemaking proceeding should be able to file pleadings for a declaratory judgment.

In order to effectuate pleadings by parties other than utility companies, provision should be made for mandatory exercise of administrative rights by a utility that is party to a controversy over tax benefit accounting.

Strenuous objection is made to the AT&T proposal for federal injunctions of state ratemaking proceedings.

4. With modifications to meet the objections and reservations described above, California will support a declaratory judgment mechanism for utility tax cases.

STATEMENT OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION ON DECLARATORY JUDGMENTS IN UTILITY TAX CASES

Mr. Chairman and members of the subcommittee, my name is Mark Chandler, and I am here to present the views of the California Public Utilities Commission, which is located at 350 McAllister Street, San Francisco, California. I appear at the request of the Commission, and at their request alone. Under the California Constitution and California law, the Commission may represent the State of California with regard to matters within its jurisdiction. I therefore speak on behalf of the people of California.

The Commission shares with you, Mr. Chairman, and with several of the other witnesses here today, an appreciation of the benefits that could accrue from the availability of a declaratory judgment mechanism such as that which underlies your bill, H.R. 229. The desirability of an early and binding determina-

tion of utility eligibility for federal tax benefits under alternative ratemaking procedures cannot be overstated. It would be unfair, however, to understate the grave and substantial reservations that California has with respect to several of the provisions of H.R. 229, and with respect to several amendments which the Treasury has indicated AT&T plans to endorse, and which are attached as an Appendix to this statement. In this testimony, I hope to elucidate those reservations, and to propose changes which should make the proposal acceptable to all parties to the regulatory process. Without such changes, California could not support the legislation.

The advantages of a declaratory judgment mechanism for determination of utility tax benefit eligibility are clear, and can be simply stated: a great deal of confusion, delay, and uncertainty would be removed from the regulatory process. The Commission believes that today, many regulators shrink from creative approaches to tax benefit accounting which could aid companies and customers alike out of uncertainty over the effect such accounting might have on eligibility. Similarly, in some situations today where such accounting procedures may already have been adopted, companies and customers alike suffer from uncertainty over eligibility. This uncertainty would be eliminated by the availability of a mechanism to determine eligibility before a final rate order went into effect.

California has six central objections to H.R. 229 and the proposed amendments, however. I will treat each of these objections in turn.

First, Section 2202(a) of the bill, which is the heart of the declaratory judgment provision, is not clearly limited to a determination of eligibility for tax purposes. In particular, objection is made to the phrase "ratemaking or accounting provisions." California would prefer to have the eligibility issue clearly stated in the legislation.

Second, it is unclear whether or not an eligibility determination would provide the basis for any additional relief, such as that presently provided for at 28 U.S. Code 2202. The Commission believes that, pursuant to long-standing national policy under the Johnson Act, 28 U.S. Code 1342, appeals of ratemaking orders should proceed through the state courts. We therefore ask that the legislation clearly provide that any demand for additional relief that may result from a given eligibility determination be pursued in the manner that is currently prescribed for seeking such relief.

Third, California objects to the limitation of the necessary party provision of Section 2202(a) to utilities, ratemaking bodies, and the Treasury. In particular, the interests of ratepayer representatives are completely ignored. Such representatives—in the form of private groups, leagues of cities, state consumer counsel, and state attorneys general—have become important and official participants in the regulatory process. Their voice deserves to be heard in all phases of the ratemaking process, and the failure to provide for their participation in any declaratory judgment proceeding is a serious oversight. The bill should provide for the joinder as a necessary part to the declaratory judgment suit of any individual or any group that is a party to the ratemaking proceeding from which the suit arises.

Fourth, the limitation of the pleading for a declaratory judgment to the public utility or the ratemaking body is inappropriate. Any proposal affecting eligibility which is raised in a ratemaking proceeding by a real party in interest to that proceeding should be eligible for a declaratory judgment. Furthermore, any real party in interest to the proceeding should be able to plead for such a judgment. Without a provision for such a pleading, the regulatory process may become tangled, and the rights of some parties may be curtailed. Since the claims of non-utility, non-regulatory participants may be the legitimate basis for appeal of a ratemaking bodies' order, it is only fair that the same judicial mechanisms be available with respect to those claims as are available with respect to the claims of other participants.

Fifth, complementary changes in Section 2202(b), regarding exhaustion of administrative remedies, will be required if the provisions regarding pleadings by non-utilities (including the pleadings by the ratemaking body for which H.R. 229 provides) are to be effective. In particular, it may be necessary to provide for mandatory exercise of administrative rights by the utility that is a party to a controversy over tax-benefit accounting.

Sixth, and finally, California objects most strenuously to the AT&T Proposed Amendment 4, which provides, "A district court may enjoin, suspend, or restrain the operation of any ratemaking order creating the controversy only until such time as the rate-making body which is a party to the action shall have issued a

subsequent rate-making order." This provision is an attempt to limit the scope of the Johnson Act, which for forty-five years has stood as a bulwark against federal judicial interference with state rate-making proceedings. The Johnson Act begins with the words, "The district court shall not enjoin, suspend, or restrain the operation of, or compliance with, any order affecting rates chargeable by a public utility. . . ." (emphasis added), and proceeds to set out a series of exceptions which have been construed most narrowly by the courts. While it is beyond the scope of this statement to discuss such interpretations in detail, suffice it to say that the Johnson Act has been instrumental in protecting from federal judical intrustion states' rights arising out of the Tenth Amendment to the Federal Constitution. For additional information, I refer the Subcommittee to an excellent and complete annotation which appears at page 422 of Volume 28 of the American Law, Reports, Federal Series.

Those, then, are California's reservations with respect to the proposed legislation. None of those reservations go to the basic purpose of the legislation, which the Commission believes admirable. Without change, however, H.R. 229 could lead to serious damage to the delicate and precarious balance that presently obtains with respect to federal and state governments, and utilities, their regulators, and their customers. Without change, California will be vigorous in its opposition to the proposal. If changes are made, however, the legislation will provide a valuable improvement to the mechanics of the regulatory process.

Thank you.

A.T. & T. Amendments—Provided by Treasury Department

Proposed declaratory judgment legislation

1. Amend Section 2201 by adding the phrase "Section 2203 and" after the words "other than actions brought under."

2. Add new Section 2203 as follows:

"(a) In a case of actual controversy within its jurisdiction between a public utility and either the Secretary of the Treasury or a ratemaking body of the United States, the District of Columbia or of a state or any of its political subdivisions, with respect to the rate-making or accounting restrictions under Sections 46(f), 176(1) or 167(m) of the Internal Revenue Code of 1954, any court of the United States, upon the filing of an appropriate pleading shall declare the rights and other legal relations of any interested party, whether or not any further relief is or could be sought. Any such declaration shall have the force and effect of a final judgment or decree and shall be reviewable as such.

(b) Petitioner.—A pleading may be filed under this section only by the public utility or by the rate-making body that issued the order creating the controversy.

(c) Necessary parties.—If a pleading is filed under this section by the public utility and either the Secretary of the Treasury or the rate-making body named as defendant, the other not so named shall be joined as a necessary party. If a pleading is filed under this section by the rate-making body and either the Secretary of the Treasury or the public utility named as defendant, the other not so named shall be joined as a necessary party.

(d) Exhaustion of administrative remedies.—The Court shall not issue a declaratory judgment or decree under this section in any proceeding unless it has determined that the public utility has exhausted administrative remedies available to it under rules and regulations promulgated by the Secretary of the Treasury. A public utility shall have exhausted its administrative remedies if either it has obtained a ruling from the Secretary of the Treasury or the Secretary has failed to issue a ruling before the expiration of 180 days after the request for such ruling was made."

3. Amend Section 1346(a) by adding after subparagraph (a)(2) the following new subparagraph:

"(3) Any action under Section 2203 with respect to the rate-making or accounting restrictions under Sections 46(f), 167(l) or 167(m) of the Internal Revenue Code of 1954."

4. Amend Section 1342 by substituting "(a) Except as provided in subsection (b), the" for the first word "The," and adding new subsection (b) as follows:

"(b) In connection with any action brought under Section 2203, a district court may enjoin, suspend or restrain the operation of any rate-making order creating the controversy only until such time as the rate-making body which is a party to the action shall have issued a subsequent rate-making order."

Mr. CHANDLER. I want also to present for the record three decisions of the California Supreme Court with respect to the matter which gave rise to the California situation.

Mr. DANIELSON. If there is no objection they will be admitted into the record at this point.

[The information follows:]

400 P.2d 708
6 Cal.3d 119

[1] CITY AND COUNTY OF SAN FRANCISCO, Petitioner,

v.

PUBLIC UTILITIES COMMISSION et al., Respondents,

PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

CONSUMERS ARISE NOW et al., Petitioners,

v.

PUBLIC UTILITIES COMMISSION, Respondent,

PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

S. F. 22794, 22793.

Supreme Court of California, In Bank.

Nov. 26, 1971.

Rehearing Denied Dec. 23, 1971.

Proceedings were brought to review a decision of the Public Utilities Commission and were consolidated. The Supreme Court, Peters, J., held that where a utility opted to account for depreciation on the straight line basis, thus incurring unnecessary income tax expense which the Public Utilities Commission properly refused to allow the utility to pass on to its customers, the Commission could, without violating due process, continue to prevent the utility from passing on such expense even after the utility's right to change the option was taken away, and the Commission erred in not considering such continuation.

Decision annulled.

1. Telecommunications ⇐302, 313

Income tax expense must be considered by Public Utilities Commission in establishing telephone and telegraph company's cost of service.

2. Public Service Commissions ⇐7.9

Public Utilities Commission has power to prevent utility from passing on to ratepayers unreasonable costs for materials and services by disallowing expenditures which Commission finds unreasonable, and this rule applies where utility resorts to accounting practices which result in unreasonably inflated tax expense.

3. Constitutional Law ⇐298(1)
Public Service Commissions ⇐7.9

Where utility opted to account for depreciation on straight line basis, thus incurring unnecessary income tax expense which Public Utilities Commission properly refused to allow utility to pass on to its customers, Commission could, without violating due process, continue to prevent utility from passing on such expense even after utility's right to change option was taken away, and Commission erred in not considering such continuation. 26 U.S.C.A. (I.R.C.1954) § 167(*l*) (2) (A, B, C), (3) (G).

4. Public Service Commissions ⇐7.4

Basic principle in rate making is to establish rate which will permit utility to recover its cost and expenses plus a reasonable return on value of property devoted to public use.

Thomas M. O'Connor, City Atty., Milton H. Mares, Deputy City Atty., and William F. Bourne, San Francisco, for City and County of San Francisco.

Garret Shean, in pro. per.

William M. Bennett, San Francisco, for Consumers Arise Now and others.

Mary Moran Pajalich and Timothy E. Treacy, San Francisco, for respondents.

Warren A. Palmer, San Francisco, as amicus curiae for respondents.

Pillsbury, Madison & Sutro, John A. Sutro, Noble K. Gregory, George H. Eckhardt, Jr., and Richard W. Odgers, San Francisco, for real party in interest.

[1] PETERS, Justice.

These are consolidated proceedings to review Decision No. 77984 of the Public Utilities Commission of the State of Cali-

fornia. The decision provides that the Pacific Telephone and Telegraph Company (Pacific) may use accelerated depreciation with the normalization method of accounting as defined in subsection (*l*) (2) (B) of section 167 of the Internal Revenue Code and that, if it elects to do so, the commission, for rate making purposes, will compute Pacific's tax expense on the basis of straight line depreciation for the purpose of establishing its cost of service and will give recognition to the normalization tax reserve in determining rate base. The decision was made effective immediately.[1]

It appears that the general approach employed by the commission for determining what constitutes permissible rates is to determine for a "test period" the costs and expenses which can be attributed to providing the service, the rate base of the utility (value of property devoted to public use), and the reasonable rate of return to be allowed the utility on its rate base. The "test period" costs, expenses, and rate base are then adjusted to allow for the effect of various known or reasonably anticipated changes. By adding the adjusted costs and expenses to the rate of return (in recent years between 5 and 8 percent) multiplied by the rate base, as adjusted, the necessary gross revenues are determined, and the rates are then fixed to produce such gross revenues. (See Pacific Tel. & Tel. Co. v. Public Utilities Comm., 62 Cal.2d 634, 643–645, 44 Cal.Rptr. 1, 401 P.2d 353.) Under this system an increase in a cost item will ordinarily be reflected as an increase in the rates, and a reduction in the rate base will produce a reduction in the rates. However, the increase in cost will be reflected in its full amount in the rates, while the reduction in the rate base will be reflected only to the extent of the reasonable rate of return, between 5 and 8 percent of the reduction.

In computing the cost of service for rate making purposes, the utility is allowed to recover its federal income taxes as a cost of business. In computing the federal income tax cost the utility is allowed to deduct depreciation, and the greater the depreciation for tax purposes (all other things being equal) the less the tax liability and the less the necessary rate to recover it.

Since 1954, the federal government has permitted straight line or accelerated depreciation in determining federal income tax liability. Straight line depreciation provides for essentially uniform annual write-offs of a depreciable asset over the life of the asset. Accelerated depreciation provides for larger allowances as expenses than straight line depreciation during the early years of the life of the asset but during later years the depreciation expense attributable to the asset will ordinarily be less than if the straight line method had been used. Because of the relation between depreciation and tax liability, it would follow in *theory* that accelerated depreciation would result in lower tax liability or tax expense in the early years as compared to straight line depreciation but that in subsequent years the tax liability would exceed that had straight line been used and thus lead to higher rates. In theory there would be lower rates in the earlier years under accelerated depreciation but higher rates in later years. However, in *practice*, the tax saving of the earlier years, although in a sense repaid in the subsequent years, does not result in higher taxes and rates in the later years because the utilities tend to increase their investment in plant and equipment every year so that the increased depreciation due to acceleration in any year will more than offset any reduced depreciation due to the effect of accelerated depreciation as to older assets.[2]

1. The decision was by Chairman J. P. Vukasin, Jr., and was signed by Commissioners William Symons, Jr., and Vernon L. Sturgeon. Chairman Vukasin, Jr., also filed a concurring opinion. Commissioners Thomas Moran and A. W. Gatov dissented.

2. In the language of the commission majority opinion: "Accelerated depreciation • • • provides for larger than straight-line annual write-offs of a depreciable asset during early years and diminishing annual write-offs during later years of the asset's life. For a given depreciable

[24] [Apparently all utilities other than Pacific and General Telephone have used accelerated depreciation in computing and paying their federal income taxes. The commission has in the past required the utilities using accelerated depreciation to pass on the tax savings to the consumer in the form of lower rates (in computing the cost of service for the purpose of fixing rates, the actual tax liability was used rather than the greater tax liability that would have been due had straight line depreciation been used for tax purposes). This passing on to the consumer of the tax savings is called "flow-through."

Pacific and General Telephone, unlike other utilities, have refused to use accelerated depreciation in filing their income tax returns. On November 6, 1968, in Decision No. 74917 the commission determined that Pacific's management was imprudent in not electing to take accelerated depreciation for income tax purposes. The commission concluded that it could not compel Pacific to take the accelerated depreciation on its federal income tax return, but it held that for purposes of rate making Pacific would be treated as if it had obtained the tax saving of accelerated depreciation and that the saving would be flowed-through to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow-through.) Notwithstanding this, Pacific continued to determine its federal tax liability using straight line depreciation.

In section 441 of the Tax Reform Act of 1969, Congress amended section 167 of the Internal Revenue Code to limit the use of accelerated depreciation by utilities in determining income tax liability. Subsection (*l*) (2) provides: "In the case of any post-1969 public utility property, the term 'reasonable allowance' [for depreciation] as used in subsection (a) means an allowance computed under—

"(A) a subsection (*l*) method [straight line depreciation (see Int.Rev.Code, § 167, subs. (*l*)(3)(F))],

"(B) a method otherwise allowable under this section [such as accelerated depreciation] if the taxpayer uses a *normalization* method of accounting, or

"(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period."[3] (Italics added.)

[25] [Subsection (*l*)(3)(G) defines normalization: "In order to use a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The commission permitted argument by interested parties in this matter. However,

asset, the total amount written off during its lifetime would be the same under either depreciation method but the rates of accruals would differ. For a group of assets of different vintages, the diminution of accruals for older plant can be obscured by the larger accruals on newer plant."

3. All utilities, other than Pacific and General Telephone, are eligible to come under clause (C) and thus continue to use accelerated depreciation for tax purposes with flow-through of the tax savings to the consumer. It would seem that Pacific and General Telephone may not resort to the option provided by clause (C) because they did not use accelerated depreciation in 1968 or in their July 1969 accounting period.

it refused to accept any evidence and struck evidence previously received (some correspondence between Pacific and the Internal Revenue Service).

The commission found that it had in its 1968 decision imputed to Pacific for tax purposes accelerated depreciation with flow-through pointing out that Pacific had an option to use accelerated depreciation; that Pacific had used straight line depreciation in its income tax returns through the year 1969, and that under the Tax Reform Act of 1969 could accelerate depreciation for tax purposes only if it normalized. The commission concluded that it would now declare that it intended to use normalization of taxes in setting Pacific's rates so that Pacific could commence acceleration under subsection (*l*)(2)(B) with regard to its 1970 taxes.

The majority opinion reasoned that the commission could not continue the existing method of imputing accelerated depreciation. The commission said of its 1968 ruling: "The imputation of accelerated depreciation with flow-through did not deprive Pacific of its property without due process because there was then no legal restriction against Pacific's changing to accelerated depreciation with flow-through and paying essentially those income taxes that had been allowed in the decision. [¶] That no longer is the case. If we now were to attempt to impute accelerated depreciation with flow-through for setting rates in this proceeding, the law clearly would preclude Pacific from actually using accelerated depreciation in filing its federal income tax returns. We thus would be assuming lower taxes than Pacific would be required by law to pay. * * * *Since accelerated depreciation with flow-through is no longer an option available to Pacific under federal law, it would now be futile to consider the relative merits of flow-through and normalization.*" (Italics added.)

We have concluded that the commission has erred in refusing to consider the merits of adhering to the 1968 method of *imputing* accelerated depreciation with flow-through and that for this reason its decision must be annulled. Under the 1968 method Pacific filed its federal income tax return on the basis of straight line depreciation but for rate purposes the tax expense was calculated on the basis of accelerated depreciation and the savings flowed-through to the ratepayers. Subsection (*l*)(2)(A), quoted above, provides that the utility may use straight line depreciation in its federal income tax returns, and there are no conditions to the resort to straight line.

The commission and Pacific do not dispute that there are no conditions to the use of straight line depreciation in the subsection. Their position is that, if straight line depreciation is used in filing the income tax return, due process requires that its tax expense for rate-making purposes be its actual tax expense and that it would be a denial of due process to *impute* accelerated depreciation in computing its tax expense for rate making purposes.

[1, 2] Income tax expense must be considered by the commission in establishing Pacific's cost of service. (See Galveston Elec. Co. v. Galveston, 258 U.S. 388, 399, 42 S.Ct. 351, 66 L.Ed. 678; Dyke Water Co. v. Public Utilities Comm., 56 Cal.2d 105, 127, 14 Cal.Rptr. 310, 363 P.2d 326.) However, "the primary purpose of the Public Utilities Act is to insure the public adequate service at reasonable rates without discrimination; and the commission has the power to prevent a utility from passing on to the ratepayers unreasonable costs for materials and services by disallowing expenditures that the commission finds unreasonable. (Pacific Tel. & Tel. Co. v. Public Utilities Comm., *supra*, 34 Cal.2d 822, 215 P.2d 441.)" (Pacific Tel. & Tel. Co. v. Public Utilities Comm., *supra*, 62 Cal.2d 634, 647, 44 Cal.Rptr. 1, 9, 401 P.2d 353, 361.)

The same rule applies where the utility resorts to accounting practices which result in unreasonably inflated tax expense. It was on the basis of this rule that the

commission in 1968 determined to *impute* accelerated depreciation to Pacific in determining its tax expense. In Decision 74917, the commission stated that for the period 1954–1967 Pacific's taxes would have been $225,000,000 less if it had used accelerated depreciation for the entire period, and that in other words, "Pacific's ratepayers might have had to pay some $450,000,000 less if Pacific had availed itself of the lawful option of using accelerated depreciation for tax purposes. * * *"[4] If it had been using accelerated depreciation, the savings in the test year would have been $27,400,000 with a resultant savings effect on gross revenues of approximately $57,000,000. (69 Cal. P.U.C. 53, 61–62.) The commission found that a "true tax saving" will continue to result from accelerated depreciation for at least as long as plant additions equal or exceed plant retirements and pointed out that without exception Pacific's witnesses foresee a continuing growth of plant, one estimate involving a doubling of plant in 10 years and compounding of growth during the next 20 years.[5] (*Id.*, at p. 62.)

The commission found that management's discretion has exceeded a reasonable and prudent course respecting income taxes to the detriment of the public interest and that it was fair and reasonable and in the public interest to compute Pacific's income tax expense for the test year on the basis of the use of accelerated depreciation beginning with plant additions in the test year. (*Id.*, at p. 90.)

[3] Under its general power to prevent a utility from passing on to its ratepayers unreasonable costs, the commission in the instant proceeding, notwithstanding the change in the federal tax statute, could properly find that the federal income tax calculated on the basis of straight line depreciation involved an unreasonable expense and that the unreasonable expense due to such calculation was due to an imprudent management decision.

Although prior to the statutory change Pacific was free to change its method of accounting on its income tax returns but now may no longer do so, its inability to switch is due to its original imprudent determination to pay federal income taxes on a straight line depreciation basis and its obstinacy after the 1968 commission decision in adhering to the imprudent determination.

As pointed out in footnote 3, any utility which used a flow-through method of accounting for its July 1969 accounting period may continue to do so under clause (C) of subsection (*l*) (2). There is no suggestion in the majority opinion or the two dissenting opinions that, if Pacific were eligible for accelerated depreciation and flow-through in paying its federal taxes, Pacific would not be required to compute its federal tax expense on such basis for rate making purposes.[6] It thus seems clear that the only reason it is not treated in this manner is that in prior years it imprudently refused to file returns on a basis of accelerated depreciation

4. Apparently the commission assumed a 50 percent tax rate.

The fact that the necessary increase of revenue is approximately double the tax expense suggests the reason why Pacific refused to shift to accelerated depreciation with flow-through when it could do so.

On the other hand, there is substantial reason, other than benefit to its ratepayers, for a utility to voluntarily switch from straight line depreciation to accelerated depreciation with flow-through. Ordinarily there will be some period during which the utility pays reduced taxes on the basis of accelerated depreciation before the commission adjusts rates to reflect the reduced payments. During that period the savings due to accelerated depreciation will inure to the benefit of the utility.

5. It should also be recognized that in the unlikely event the rate of investment should decrease, there could be a net tax increase in a given year but that so long as the utility remains a going concern and must continue with some investment there will be an overall tax saving while it continues accelerated depreciation. In other words, so long as there is a single dollar of new investment, there will be a tax deferral.

6. The concurring opinion of Chairman Vukasin, Jr., suggests a contrary view.

tion and then after the 1968 decision obstinately continued in its imprudent refusal.

The effect of Pacific's refusal in 1968 to switch to accelerated depreciation was to cast a significant burden on itself. By refusing to switch to accelerated depreciation in filing its income tax returns after it was aware that such depreciation would be imputed to it for rate making purposes in calculating federal tax expense, Pacific in essence placed itself in the position of paying a large income tax bill, part of which was unnecessary and was not to be recovered in higher rates. As to that part, Pacific in a sense placed itself in the position of having to raise additional funds, either debt or investment. Nevertheless, Pacific chose to do so.

It should also be pointed out that the effect of the instant decision is to permit Pacific to include as an expense for rate making purposes a large amount of federal income taxes which it will not be required to pay in the foreseeable future. Although the majority opinion ignores this matter, the concurring opinion and the two dissenting opinions recognize that accelerated depreciation and normalization will result in the ratepayers contributing capital to Pacific. As the concurring opinion points out, this method of accounting will "provide a source of interest-free capital." We do not know how much capital will be provided, but the dissenting commissioners estimate that the ratepayers in the next 10 years will have to provide between $750,000,000 and one billion dollars. Commissioner Moran in his dissenting opinion states that if the ratepayers are required to put up the capital for the telephone system, it "is indeed a step toward socialism and logically could lead ultimately only to government ownership of the telephone system * * *."

[4] Although Commissioner Moran may be overstating the matter, it is clear that requiring ratepayers to put up the capital for the telephone system is contrary to the basic principle of utility rate setting. The basic principle is to establish a rate which will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use. (Pacific Tel. & Tel. Co. v. Public Util. Comm., *supra*, 62 Cal.2d 634, 644–645, 44 Cal.Rptr. 1, 401 P.2d 353.) By permitting Pacific to include in its costs a charge for federal taxes greatly in excess of its actual federal tax expense, the commission is deviating from this basic principle. We realize that the 1968 commission decision also deviated from the basic principle by refusing to permit Pacific to include in its costs all of its tax expense, but this deviation was based on Pacific's imprudent management.

It should also be pointed out that the effect of the instant decision is to reward Pacific for its imprudent management as compared to other utilities which prudently had adopted accelerated depreciation and flow-through prior to August, 1969. Apparently, these utilities will continue to be required to flow-through the benefits of accelerated depreciation to the ratepayers, whereas Pacific will be allowed to use accelerated depreciation without requiring flow-through, thus retaining most of the benefits for itself.

In the circumstances, we are satisfied that, in the light of Pacific's past imprudence, the commission could reasonably have ordered Pacific to continue the accounting practices established in the 1968 decision and that the commission abused its discretion in expressly *refusing to consider* imputed acceleration depreciation and flow-through as established in the 1968 decision.

The argument that in the light of the federal tax amendment there will be a denial of due process in continuing the 1968 treatment falls on its face in view of Pacific's conduct. Prior to the federal tax amendment and after the 1968 decision of the commission, Pacific could have elected to change its accounting procedures in filing its returns and thereby saved substantial tax expense. Pacific, however, chose not to do so. The only effect of the

federal tax amendment is to take away the option which Pacific had already rejected. Requiring Pacific to do that which it had freely chosen to do cannot be said to be a denial of due process. In other words, after the 1968 decision, Pacific, if it chose
[1b] could have opted for accelerated depreciation on its tax returns. It did not do so. Had it done so, Pacific could have used accelerated depreciation with flow-through. Now the option to switch to accelerated depreciation and flow-through has been terminated, but even assuming the absence of the option is a matter to consider by the commission, it does not mean that continuation of the 1968 treatment will result in a denial of due process.

For failure to consider lawful alternatives in calculation of federal income tax expense, the decision of the commission must be annulled. (Cf. Northern California Power Agency v. Public Util. Com., 5 Cal.3d 370, 380, 96 Cal.Rptr. 18, 486 P.2d 1218.) Upon further consideration the commission should consider whether to adhere to the 1968 method of determining federal income tax expense and whether to adopt the accelerated depreciation and normalization method adopted by the decision before us. Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax law are either harsh on the utility or the ratepayers, the commission may also consider alternative approaches which strike a balance between these two extremes.

The 1968 method of imputed accelerated depreciation and flow-through is favorable to the ratepayer but harsh on Pacific. In terms of the 1967 figures, as compared to straight line depreciation for tax purposes, this method would save the ratepayer 54 million dollars but Pacific would in a sense be penalized 27 million dollars. The method adopted by the decision before us is harsh on the ratepayer who under the 1967 figures will be compelled to lose most of the 54 million dollar saving but is beneficial to Pacific which will be permitted rates including the 54 million.

These two methods are extremes when compared to the nontelephone utilities which, having switched to accelerated depreciation with flow-through prior to 1970, may continue with that method and permit the ratepayers the consequent reduction without being compelled to pay the tax on the basis of straight line depreciation. Although the method open to the nontelephone utilities is not open to Pacific, the commission is not compelled to adopt one of the two extremes set forth above but may adopt a compromise striking a proper balance between the interests of the ratepayers and Pacific in the light of current federal income tax statutes.

Both of the extreme methods involve a fictitious charge of federal tax expense. The 1968 method deliberately understates the actual tax expense on the basis of the imprudent management of Pacific. The method adopted in the decision before us deliberately overstates the actual tax expense in order to normalize. Since a fictitious figure must be used under either
[1a] method, it is not improper for the commission to use an additional fictitious factor to limit the harsh results. Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections.

The decision is annulled.

WRIGHT, C. J., and McCOMB, TOBRINER, MOSK, BURKE and SCHAUER,* JJ., concur.

Rehearing denied; SULLIVAN, J., did not participate.

* Retired Associate Justice of the Supreme Court sitting under assignment by the Chairman of the Judicial Council.

contention that the trial judge did not properly consider the motion for nonsuit because of an alleged animosity towards plaintiffs' case.

The judgment is reversed.

WRIGHT, C. J., and PETERS, TOBRINER, and MOSK, JJ., concur.

BURKE, Justice (concurring and dissenting).

I concur with the majority to the extent they hold that the state's liability could be based upon its alleged concurrent negligence [1230] in failing to warn of a dangerous condition. (Gov.Code, § 830.8.) I dissent, however, from the majority's determination that the state has failed to establish its design immunity under Government Code section 830.6.

The evidence showed that the Santa Cruz Board of Supervisors approved design plans which disclosed the course of the proposed road and the elevation of the white center stripe of the road. Although the plans, drafted in the 1920's, did not contain actual superelevation figures, that omission should not deprive the state of its design immunity under section 830.6. Given the curvature of the road and the elevation of its center line, the preparation of superelevation figures would appear to be a matter of mere mathematical calculation, or at least a mechanical engineering task to be performed in the normal fashion in accordance with the standards existing in the 1920's.

Indeed, the evidence in this case was that the road was superelevated in a normal and reasonable fashion, in accordance with then-existing standards. I find nothing in section 830.6 which would require that the approved plans expressly contain each and every element alleged to have contributed to a subsequent accident, in order to preserve the design immunity. It should be enough to show, as in this case, that the plans contemplated or incorporated by necessary implication normal or calculable construction or design standards. Under the circumstances in this case I think the state carried its burden of establishing its design immunity under section 830.6.

McCOMB, J., concurs.

Rehearing denied; McCOMB and BURKE, JJ., dissenting.

497 P.2d 785
7 Cal.3d 331

CITY OF LOS ANGELES et al., Petitioners, [1231]
v.
PUBLIC UTILITIES COMMISSION et al., Respondents;
PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

William M. BENNETT et al., Petitioners,
v.
PUBLIC UTILITIES COMMISSION, Respondent;
PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

CALIFORNIA PUBLIC INTEREST LAW CENTER et al., Petitioners,
v.
PUBLIC UTILITIES COMMISSION, Respondent;
PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

S. F. 22832, 22826 and 22833.

Supreme Court of California,
In Bank.
June 9, 1972.
As Modified on Denial of Rehearing
July 12, 1972.

Consolidated proceeding to review decision of Public Utilities Commission authorizing intrastate telephone rate increases. The Supreme Court, Peters, J., held that where portions of Public Utilities Commission's decision dealing with treatment of federal and state tax expense, adjustment of price paid for equipment to related corporation and certain capital expenditures which did not increase revenue

could not be sustained on the record and it was possible that amount of money involved was equal to or exceeded the amount of the increase, the order increasing rates must be annulled in its entirety and Commission must reinstate rates of its last preceding lawful order, but it might grant interim rate increases upon appropriate findings.

Mosk, J., filed concurring and dissenting opinion.

Schauer, retired Associate Justice of Supreme Court, sat under assignment by Chairman of the Judicial Council.

1. Public Service Commissions ⇐7.1, 18

Public Utilities Commission in rate-making proceeding has discretion to determine factors material to public convenience and necessity but is required to state what those factors are and to make findings on material issues which ensue from the factors. West's Ann.Public Util.Code, § 1705.

2. Telecommunications ⇐343

Where Public Utilities Commission, in connection with issuing telephone rate order, followed its tax expense decision in earlier proceeding, but that decision was annulled and, unless the rate order were annulled, rate would become lawful and all funds collected pursuant to order would belong to telephone company and not be subject to refund, the order must be annulled. West's Ann.Public Util.Code, § 1705.

3. Telecommunications ⇐343

Where sole basis for accounting and rate-making treatment of state taxes of telephone company was the annulled decision in another case as to treatment of federal taxes, decision in telephone company case, to extent it related to the state taxes, could not be sustained. West's Ann.Public Util.Code, § 1705.

4. Telecommunications ⇐341

Public Utilities Commission's decision as to accounting and rate-making treatment for state taxes of telephone company could not be upheld on theory that the amount involved was insignificant, where it appeared that on basis of that decision there might be rate increases amounting to $200,000,000 in the following ten years. West's Ann.Public Util.Code, § 1705.

5. Telecommunications ⇐341

Public Utilities Commission's treatment, for accounting and rate-making purposes, of state taxes on basis of accelerated depreciation with normalization could not be upheld on theory of administrative convenience where no additional computations would be required to apply accelerated depreciation with flow through. West's Ann.Public Util.Code, § 1705.

6. Telecommunications ⇐319

Goal of uniformity between treatment of federal and state tax expense did not justify treatment of state tax of telephone company on basis of accelerated depreciation with normalization in rate-making decision, where federal and state law were not the same as to use of accelerated depreciation, there was potentially a large amount of money involved in increased rates that would result from such treatment of state tax expense and there was no administrative inconvenience in applying instead accelerated depreciation with flow through. West's Ann.Public Util. Code, § 1705.

7. Telecommunications ⇐319

Telephone company's adherence to ordinary principles of accelerated depreciation with flow through with regard to state taxes for purposes of rate-making would not have jeopardized its federal tax benefits that would result if normalization method of accounting could be used. 26 U.S.C.A. (I.R.C.1954) §§ 167(l) (2), (3) (G).

8. Corporations ⇐1.6(1)

Where it appears that utility is dominant, it may not through use of corporate instrumentalities obtain a greater rate of return than it would be entitled to in the absence of such; it is not determinative whether the prices charged by one affiliated corporation to another might be considered reasonable; the utility enterprise

must be viewed as a whole without regard to the separate corporate entities and rate of return should be the same for the entire utility enterprise.

9. Telecommunications ⇐317

Where parent corporation was designer, engineer, manufacturer, distributor, installer, repairer and operator of 80% of telephone business in entire continental United States, telephone equipment manufacturer was wholly owned subsidiary and parent held 90% voting control of operating utilities company, the manufacturer was not entitled to greater rate of return on its sales to the utility, for purposes of fixing utility's rates, than that utility was entitled to earn in its operations, even if manufacturer's prices were reasonable when compared to other manufacturing enterprises. West's Ann.Public Util.Code, § 1705.

10. Telecommunications ⇐317

In determining rate of telephone company which was part of a utility enterprise, increased rate of return permitted for activities of supplier of telephone equipment, under the part of the utility enterprise could not be sustained on theory that it represented a reward for efficiency, where commission failed to specify any amount of such reward and there was no way of determining amount of increase rate of return permitted as reward for efficiency from part of increase due to other factors. West's Ann.Public Util.Code, § 456.

11. Public Service Commissions ⇐18

When Public Utilities Commission sees fit to permit a reward for efficiency pursuant to public utilities code, it must specify the amount of the reward, since, if it fails to do so, it becomes impossible to review the decision of the Commission and, in addition, rate payers are entitled to know amount of any reward included in their rate, since it is their money that is being used for the reward. West's Ann. Public Util.Code, § 456.

12. Telecommunications ⇐330

Evidence supported Public Utilities Commission's finding as to amount of expenditure by telephone company for improvements which would not be expected to produce any substantial increase in revenues, which were important part of revenue producing system and which were used to increase average year rate base in determining telephone rates. West's Ann.Public Util.Code, § 1705.

13. Telecommunications ⇐313, 318

Within rule that Public Utilities Commission in rate-making determines revenues, expenses and investments for test year and adjusts test period results to allow for reasonably anticipated changes in revenues, expenses, or other condition, so that the test period results of operations will be as nearly representative of future conditions as possible, the Commission may not adjust one side or part of the equation without adjusting the other, unless there is a finding that the particular expenditure is extraordinary. West's Ann.Public Util. Code, § 1705.

14. Telecommunications ⇐313

In determination by Public Utilities Commission of telephone rates, wherein there was no finding that certain telephone company investment which would not produce increased revenues was extraordinary or that the anticipated increase in revenues for future years were insufficient to offset anticipated increase in expenses and investment, commission was not justified in adjusting the average year rate base to reflect such investments by "rolling back" such investment into the test year. West's Ann.Public Util.Code, § 1705.

15. Telecommunications ⇐313

For purposes of determining rate for telephone company, adjustment of average year rate base to reflect capital expenditures which would not increase revenue was not warranted to offset effects of inflation. West's Ann.Public Util.Code, § 456.

16. Telecommunications ⇐316

Rate of return of 7.85% for telephone company, with 9.5% on common equity, was within range of reasonableness and

Public Utilities Commission did not abuse its discretion in fixing such rate. West's Ann.Public Util.Code, § 456.

17. Telecommunications ⇐317

Since, in light of dominance of telephone system and its integrated position, utility enterprise must be viewed as a whole without regard to separate corporate entities, Public Utilities Commission, in setting rates for subsidiary telephone company, properly used actual costs of basic research, assistance in engineering, legal, accounting, financing and other services rendered by parent to subsidiary, rather than the one percent of subsidiary's gross revenue paid to parent for such services. West's Ann.Public Util.Code, § 456.

18. Telecommunications ⇐321

Increase in basic charge for "life line service" to telephone subscribers from $2.25 per month, with message allowance of 30 units, to $2.95 with message allowance of 20 could not be sustained on the record.

19. Telecommunications ⇐261

Public Utilities Code authorizes Commission to order telephone company to make changes to secure adequate service or facilities. West's Ann.Public Util.Code, §§ 761, 762.

20. Telecommunications ⇐336

Upon Public Utilities Commission finding that plant additions of at least $750,000,000 per year by telephone company for the following three years would decrease likelihood of service problems, Commission had authority to order telephone company to install $750,000,000 of plant additions for each of the three years, especially since Commission had power to review specific expenditures made from the gross amount and to disallow as an expense any which it considered unjustified or wasteful. West's Ann.Public Util.Code, §§ 761, 762.

21. Telecommunications ⇐336

Public Utilities Commission's findings that plant additions of at least $750,000,000 per year by telephone company for following three years would decrease likelihood of service problems was sufficiently specific to satisfy requirements of section of Public Utilities Code providing that Commission's decision in rate-making case shall contain, separately stated, findings of fact and conclusions of law on all issues material to the order or decision. West's Ann. Public Util.Code, §§ 761, 762, 1705.

22. Public Service Commission ⇐24

When conflicting evidence is presented from which conflicting inferences can be drawn, the Public Utilities Commission's findings are final. West's Ann.Public Util.Code, §§ 761, 762, 1705.

23. Telecommunications ⇐313

Even though telephone company was monopoly with captive consumers, expenditure for advertising which should result in reductions in operating costs and more efficient service to rate payer were reasonable operating expenses and properly allowed in rate-fixing case. West's Ann. Public Util.Code, §§ 761, 762.

24. Telecommunications ⇐330

Evidence supported increase in telephone company's rate and installation charges for equipment and service functions. West's Ann.Public Util.Code, §§ 761, 762.

25. Telecommunications ⇐33

Where petitioner had been issued three subpoenas to compel attendance of telephone company's president and two other corporate officers at public hearings involving telephone rate increases but had delayed serving subpoenas for 14 days until eve of the return date, Public Utilities Commission did not abuse its discretion in quashing subpoenas on ground they had not been properly served. West's Ann. Code Civ.Proc. § 1987.

26. Public Service Commission ⇐21

Innuendos of misconduct, in absence of specific allegations, were insufficient basis for review of propriety of meeting of Public Utilities Commissioners at an airport on July 4 in connection with filing of amended petition for rehearing of Commission's decision in rate case. West's Ann. Public Util.Code, § 306.

27. Telecommunications ⇐344

Once it had been determined that telephone rate increases were invalid, increases could not be continued in effect until Public Utilities Commission established new rates.

28. Telecommunications ⇐343, 344

Where, in telephone rate case, portions of Public Utilities Commission's decision dealing with treatment of federal and state tax expense, adjustment of price paid for equipment to related corporation and certain capital expenditures which did not increase revenue could not be sustained on the record and it was possible that amount of money involved was equal to or exceeded the amount of the increase, the nrder increasing rates must be annulled in its entirety and Commission must reinstate rates of its last preceding lawful order, but it might grant interim rate increases upon appropriate findings. West's Ann.Public Util.Code, § 1705.

29. Public Service Commissions ⇐7.1

Public Utilities Commission has power to prescribe rates prospectively only and Commission cannot, even on grounds of unreasonableness, require refunds of charges fixed by formal finding which has become final. West's Ann.Public Util. Code, § 728.

30. Telecommunications ⇐343

Where telephone rate increases authorized by Public Utilities Commission were annulled, telephone company was not entitled to have case remanded to Commission to set a new lawful rate and to have refunds limited to difference, if any, between rate set in decision and rate set in the further proceedings, inasmuch as that would involve proscribed retroactive rate-making. West's Ann.Public Util.Code, § 728.

William M. Bennett, in pro. per.

Roger Arnebergh, City Atty., Charles E. Mattson, Deputy City Atty., John W. Witt, City Atty., William H. Kronberger, Jr., Deputy City Atty., Thomas M. O'Connor, City Atty., Milton H. Mares and William F. Bourne, Deputy City Attys., W. Keith Woodmansee, Walnut Creek, Michael M. Stein, Beverly Hills, and Rinaldo S. Brutoco, Los Angeles, for petitioners.

Mary Moran Pajalich and Timothy E. Treacy, San Francisco, for respondents.

PETERS, Justice. 1194

In these consolidated proceedings we review Decision No. 78851 of the Public Utilities Commission which authorizes intrastate telephone rate increases in the amount of $143 million annually. We have issued a partial stay providing that all sums collected by Pacific Telephone and Telegraph Company pursuant to the rates authorized by the decision shall be subject to refund in whole or in part upon order of this court should the decision or Decision No. 77984 of the commission be annulled or modified. The latter decision, which related to the calculation of Pacific's federal income tax expense for rate making purposes was rendered during the course of the proceedings which subsequently resulted in the instant rate decision, and we recently annulled the tax expense decision in City & County of San Francisco v. Public Utilities Com., 6 Cal.3d 119, 98 Cal.Rptr. 286, 490 P.2d 798.

In Pacific Tel. & Tel. Co. v. Public Util. Com., 62 Cal.2d 634, 644-645, 44 Cal.Rptr. 1, 7, 401 P.2d 353, 359 the commission's general approach was described as follows: "It appears that in telephone rate proceedings in California the general approach employed by the commission, and followed in the present case, is to determine with respect to a 'test period' (1) the rate base of the utility, i. e., value of the property devoted to public use, (2) gross operating revenues, and (3) costs and expenses allowed for rate-making purposes, resulting in (4) net revenues produced, sometimes termed 'results of operations.' Then, by determining the fair and reasonable rate of return to be fixed or allowed the utility upon its rate base, and comparing the net revenue which would be achieved at that rate with the net revenue of the test period, the commission determines whether and

how much the utility's rates and charges should be raised or lowered. . . . The test period is chosen with the objective that it present as nearly as possible the operating conditions of the utility which are known or expected to pertain during the future months or years for which the commission proposes to fix rates. The test-period results are 'adjusted' to allow for the effect of various known or reasonably anticipated changes in gross revenues, expenses or other conditions, which did not obtain throughout the test period but which are reasonably expected to prevail during the future period for which rates are to be fixed, so that the test-period results of operations as determined by the commission will be as nearly representative of future conditions as possible."

[1b7] The same general approach was followed in the instant proceedings, using 1970 as the test year.

In 1961, section 1705 of the Public Utilities Code was amended to provide that ". . . the commission shall make and file its order, containing its decision. The decision shall contain, *separately stated, findings of fact and conclusions of law* by the commission *on all issues materiel to the order* or decision. . . ." (Italics added.)

[1] In California Motor Transport Co. v. Public Utilities Com., 59 Cal.2d 270, 273–275, 28 Cal.Rptr. 868, 870, 379 P.2d 324, 326, this court reviewed a commission order applying the new scope of review dictated by the amendment of section 1705. We held that a finding of "public convenience and necessity" was an ultimate finding and that to be sustained by the court "[e]very issue that must be resolved to reach that ultimate finding is 'material to the order . . . .'" and must be separately stated. The decision left to the commission the discretion to determine the factors material to public convenience and necessity but held that section 1705 requires it to state what those factors are and to make findings on the material issues which ensue from the factors.

It has been repeatedly emphasized that separate findings are essential to "afford a rational basis for judicial review and assist the reviewing court to ascertain the principles relied upon by the commission and to determine whether it acted arbitrarily, as well as assist parties to know why the case was lost and to prepare for rehearing or review, assist others planning activities involving similar questions, and serve to help the commission avoid careless or arbitrary action." (Greyhound Lines, Inc. v. Public Utilities Com. 65 Cal.2d 811, 813, 56 Cal. Rptr. 484, 485, 423 P.2d 556, 557; Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 648, 44 Cal.Rptr. 1, 401 P.2d 353; California Motor Transport Co. v. Public Utilities Com., *supra*, 59 Cal.2d 270, 274–275, 28 Cal.Rptr. 868, 379 P.2d 324.) We must review the findings accordingly.

FEDERAL TAX EXPENSE

[2] Our decision annulling the commission's tax expense decision in City & County of San Francisco v. Public Utilities Com., *supra*, 6 Cal.3d 119, 98 Cal.Rptr. 286, 490 P.2d 798, was filed after the commission had established the rates before us. The commission in the instant decision in fixing the amount of Pacific's federal tax expense followed its tax expense decision. Since the latter decision was annulled, the instant decision must also be annulled.[5]

[1b8] The fact that the commission reopened the proceedings with respect to the question of federal income tax expense after our decision does not militate against this conclusion. In Pacific Tel. & Tel. Co. v.

t. It is not clear how much of the $143 million annual increase is due to the commission's change in the treatment of federal tax expense. As pointed out in our opinion in City & County of San Francisco v. Public Utilities Com., *supra*, 6 Cal.3d 119, 125, 98 Cal.Rptr. 286, 490 P. 2d 798, the commission refused to take evidence. The dissenting commissioners in Decision No. 77084, *supra*, estimated that the increased rates in the next 10 years due to the commission's tax expense decision would be between 750 million and one billion dollars.

Public Util. Com., *supra*, 62 Cal.2d 634, 649-656, 44 Cal.Rptr. 1, 401 P.2d 353, the commission commenced an investigation into the lawfulness of Pacific's rates, after lengthy hearings it concluded that the rates were excessive, it ordered new, lower rates, and it ordered a refund of excessive rates in the amount of $80 million collected by Pacific during the pendency of the rate proceedings. We annulled the refund order on the ground that general rate making is legislative and looks to the future, that the Legislature has authorized rate changes only for the future, and that the commission did not have power to order refunds on the ground of unreasonableness where the rate had been previously found to be reasonable. It follows that, unless the rate order now before us is annulled, it will become a lawful rate and that all funds collected pursuant to it would belong to Pacific and not be subject to refund.

In other words, we must annul the rate order now before us, because otherwise the rates therein, which are based in part on the annulled tax expense decision, will become lawful rates for the future and will preclude refunds.

STATE TAX EXPENSE

The commission concluded that for purposes of computing the expense allowance for Pacific's state corporation franchise tax liability, it would follow the same accounting procedures as to depreciation as the federal tax expense computation, i. e., accelerated depreciation with normalization. Under the commission's 1968 decision, the accounting procedure followed was imputed accelerated depreciation with flow through.

Accelerated depreciation for tax purposes results in a tax saving or deferral. (See City & County of San Francisco v. Public Utilities Com., *supra*, 6 Cal.3d 119, 123, 98 Cal.Rptr. 286, 490 P.2d 798.)

The problem presented is whether the tax saving or tax deferral should inure to the benefit of the ratepayer in the form of lower rates or whether the tax saving or deferral should be retained by the utility with no reduction in rates. When the saving is passed on to the ratepayer, the accounting procedure is called accelerated depreciation with flow through.[2] When the 1139
saving is retained by the utility, the accounting procedure is called accelerated depreciation with normalization.[3]

2. Apparently, all utilities in California except Pacific and General Telephone follow accelerated depreciation with flow through as to both federal and state income tax expense. Pacific and General Telephone have apparently in the past used straight line depreciation. In 1968, the commission, recognizing that it could not compel Pacific and General Telephone to change its tax practices, nevertheless concluded that the two corporations were acting imprudently and determined that for purpose of rates, it would *impute* accelerated depreciation to them with flow through of the *imputed* tax savings to the ratepayer.

3. Accelerated depreciation with normalization means that the utility pays its income or franchise tax on the basis of accelerated depreciation. The commission, for rate purposes, then recomputes what would have been the tax liability if straight line had been used, and this amount is treated as the tax expense to be recovered by the utility through its rates as an expense of doing business. The difference between the actual liability for taxes of the corporation and the recomputed taxes on the basis of straight line is then set up on the books as a reserve for deferred taxes.

The system followed by nontelephone utilities, accelerated depreciation with flow through, is that the utility pays taxes on the basis of accelerated depreciation and the actual tax expense is the amount allowed as tax expense for rate purposes.

The third system, *imputed* accelerated depreciation with flow through, which was applied to Pacific and General Telephone in 1968, is that the utility pays its taxes on the basis of straight line depreciation but the commission recomputes those taxes as if accelerated depreciation had been used, and only this latter figure is allowed as a tax expense for rate purposes.

In the decision which we annulled the commission held that Pacific's *federal* income tax expense would be computed for rate making purposes on the basis of accelerated depreciation with normalization, and in the instant decision the commission concluded that *state* corporation tax expense would also be computed on the basis of accelerated depreciation with normalization.[4] The commission reasoned: "If Pacific were to adopt 'flow-through' accounting for state income taxes using accelerated depreciation, it would not appear to be in compliance with the prerequisite in the Internal Revenue Code that a taxpayer such as Pacific must use the 'normalization method of accounting' to qualify for the use of accelerated depreciation for federal income tax purposes. In any event, the state income taxes are a relatively small portion of total income taxes paid by Pacific. Under these circumstances it is not warranted to consider different accounting and rate-making treatment for state than for federal taxes. We find that the staff was correct in basing its determination of revenue requirement in Exhibit No. 66 on the use of normalization for both state and federal income taxes. This avoids the possibility of jeopardizing the much larger federal income tax deferrals."

[3] The above quoted matters constitute the only discussion by the commission of the depreciation allowance as to state corporation franchise taxes. We have annulled the decision of the commission establishing accelerated depreciation and normalization as the method of computation of federal tax expense in City & County of San Francisco, *supra*. Since the sole basis for the instant decision as to state taxes was the annulled decision as to federal taxes, the instant decision, to the extent it relates to the state taxes, cannot be sustained.

Moreover, even if the decision as to the treatment of federal taxes had been permitted to stand, the commission's determination as to state taxes could not be upheld.

[4] The commission's decision may not be upheld on the theory that the amount involved is insignificant. The commission's Table If, Results of Intrastate Operations Under Present Rates—Test Year 1970, reflects that for the test year the adopted federal taxes were $101,800,000 and the adopted state taxes were $19 million. Thus the ratio is approximately five to one. It seems reasonable to assume that the same ratio would apply with regard to tax savings. Thus under the $750 million to $1 billion estimate of rate increase in the next 10 years due to the federal tax decision, there may be rate increases amounting to $200 million in the next 10 years due to the instant decision's treatment of state tax expense. There is no showing before us which would warrant the conclusion that the amount of money involved is negligible; the commission, so far as appears, did not take evidence as to the effect on state tax expense of the instant decision as compared to alternative treatment. Accordingly, it would be improper to assume that only a trivial amount of money is involved, and the commission's decision cannot be upheld on the theory that the importance of the decision as to state tax treatment is minimal.

[5] Nor may the commission's state tax treatment be upheld on a theory of administrative convenience. No additional computations are required to apply accelerated depreciation with flow through. Pacific will be paying its taxes on the basis of accelerated depreciation, and this figure would thus be readily available. Moreover, in order to establish the tax reserve used in normalization, it is essential to calculate in the rate books the tax which will be paid on the basis of accelerated depreciation and which would have been due without accelerated depreciation. (See fn. 3.)

4. The federal tax expense decision was based on a change in federal tax law. There has been no comparable change in our corporate franchise tax law. Thus, the commission could not and did not in the instant decision rely on the grounds in the federal decision.

[6] Although the goal of uniformity between treatment of federal and state tax expense may sometimes furnish a basis for adoption of particular rate procedures, uniformity does not justify the state tax treatment adopted by the commission. As pointed out above, federal law and state law are not the same with respect to the use of accelerated depreciation. Thus, the [341] same considerations do not apply. In the light of the potentially large amount of money involved and the lack of any administrative inconvenience, the limited uniformity sought by the commission as to depreciation would not justify the substantial departure from ordinary principles of rate making.[5]

[7] We cannot agree that to adhere to the ordinary principle of accelerated depreciation with flow through with regard to state taxes would jeopardize Pacific's federal tax benefits.[6]

Section 167(*l*) (2) of the Internal Revenue Code, as amended in 1969, provides: "In the case of any post-1969 public utility property, the term 'reasonable allowance' [for depreciation] as used in subsection (a) means an allowance computed under—

"(A) a subsection (*l*) method [straight line depreciation (see Int.Rev. Code, § 167, subs. (*l*) (3) (f))],

"(B) a method otherwise allowable under this section [such as accelerated depreciation] *if the taxpayer uses a normalization method of accounting*, or

"(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period." (Italics added.)

Subsection (*l*) (3) (G) defines normalization: "In order to use a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation *under this section*, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the *taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.*" (Italics added.)

When section 167(*l*) (3) (G) (ii) is read [342] as a whole, it is clear that the reserve for deferred taxes need only reflect the deferral of taxes resulting from the use of "such" different methods of depreciation and that such different methods of depreciation mean the difference in the allowance for depreciation "under this section." The term "under this section," of course, refers only to federal taxes and not to state taxes.

For the foregoing reasons, the computation of state tax expense cannot be sustained.

THE WESTERN ELECTRIC ADJUSTMENT

In prior rate proceedings involving Pacific, the commission generally adopted certain adjustments to Pacific's plant and

5. We pointed out in City & County of San Francisco, *supra*, that the general rule followed by all nontelephone utilities is accelerated depreciation with flow through. Thus the instant decision represents a departure from the basic principle governing treatment of tax expense. (6 Cal.3d at pp. 124, 129, 98 Cal.Rptr. 280, 490 P.2d 798.)

6. We assume for the purpose of discussion and contrary to fact that we affirmed the federal tax decision of the commission. Of course we annulled it. Since the commission must reconsider the federal tax treatment it is only speculative that there will be any federal tax benefits for Pacific.

expenses to establish lower prices than those actually charged Pacific by its affiliated manufacturer, Western Electric Company, Inc. Western is a wholly owned subsidiary of American Telephone and Telegraph Company, and American holds 90 percent voting control of Pacific. The reductions were based on the theory that Western should be entitled to no greater rate of return than would be reasonable for a regulated utility.

In the instant decision, the commission concluded that no adjustment should be made. The commission refused to make the adjustment not only as to current purchases by Pacific from Western but also refused to make the adjustment with respect to equipment and plant purchased prior to 1968, the last year the adjustment was made in setting Pacific's rates.

The commission pointed out that Western during the years 1946 through 1969 had received a return on net equity from its Bell System operations of 10.1 to 10.2 percent. (This, of course, is substantially higher than the return permitted Pacific during the period or in the current proceeding.) The commission found that Western was efficiently operated, and pointed out that section 456 of the Public Utilities Code permits incentives and rewards for a more efficient management of an enterprise.[7]

The basis of the commission's decision is that, as to the activities of Western, a rate of return should be permitted commensurate to an ordinary manufacturer's rate of return and that when Western is permitted such return, its prices were reasonable.[8]

We extensively considered the Western Electric adjustment in Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 659–662, 44 Cal.Rptr. 1, 401 P.2d 353. We set forth the commission's findings as

7. Section 456 of the Public Utilities Code provides: "Nothing in this part shall be construed to prohibit any public utility from profiting, to the extent permitted by the commission, from any economies, efficiencies, or improvements which it may make, and from distributing by way of dividends, or otherwise disposing of, such profits. The commission may make or permit such arrangement with any public utility as it deems wise for the purpose of encouraging economies, efficiencies, or improvements and securing to the public utility making them such portion of the profits thereof as the commission determines."

8. The commission reasoned: "The intent of Section 456 also should apply to an affiliate of a California utility. It is quite possible that the risks inherent in the manufacturing operations and in the service and supply operations of Western Electric are not quite as great as the operating risks of some of the manufacturers used in the comparative data presented in this proceeding. There is no question, however, that the capital structure of Western Electric is similar to that of manufacturers. There is also ample evidence that Western Electric has been operated in an extremely efficient manner, as compared with other enterprises. Considering the risks and efficiencies of Western Electric's total operations, we deem it reasonable for Western Electric to have earned the returns it realized from 1946 through 1969. No adjustment to the prices charged Pacific for products and services during that period is warranted.

"Further tests of reasonableness are appropriate in reviewing the manufacturing functions and the service and supply functions performed by Western Electric. Also, although manufacturing is not a normal function of a utility, such service and supply functions as purchasing from other manufacturers, storekeeping, installing, repairing and salvaging are normal utility functions. Even though Western Electric did not earn an unreasonably high return on its operations, a downward adjustment in prices charged would be appropriate if Western Electric prices for manufactured products were higher than similar products manufactured by others or if Pacific could perform the service and supply functions at lower cost than the charges by Western Electric. . . . Exhibits Nos. 8 and 8–A show that it would cost at least $14,500,000 more per year for Pacific to duplicate the service and supply functions now performed by Western Electric. These exhibits confirm that no adjustment to Western Electric prices for manufactured products or for services and supplies is warranted at this time."

to the corporate affiliation of Pacific, Western, and American, as to the dominance of the Bell System in providing telephone service, and as to its advantage in its integrated position of being researcher, designer, engineer, manufacturer, distributor, installer, repairer, junker, and operator of 80 percent of the telephone business in the entire continental United States. Those findings were not disputed by Pacific. We concluded: "The determination of the commission in the present case that Western is entitled to no greater return on its sales to Pacific than Pacific is entitled to earn on its operations, and that American should not be permitted through the corporate instrument of Western to subject Pacific's ratepayers to the burden of providing a greater return, is based not only on extensive findings made by the commission on the subject but also on the methods and principle theretofore followed by the commission . . . and as the commission expressly found herein, produces a fair and reasonable result." (62 Cal.2d at pp. 661–662, 44 Cal.Rptr. at p. 18, 401 P.2d at p. 370.) We rejected Pacific's contention that it was error for the commission to omit "to include a finding of fact as to the reasonableness or prudence of Pacific's
[1a] purchases from Western and payment of the prices charged, . . ." (62 Cal.2d at p. 661, 44 Cal.Rptr. at p. 18, 401 P.2d at p. 370.)

[8] We thus determined that, where it appears that a utility enjoys the dominant position shown by the commission's findings, it may not through the use of corporate instrumentalities obtain a greater rate of return than the utility would be entitled to in the absence of the separate corporate entities, and it was not determinative whether the prices charged by one affiliated corporation to another might be considered reasonable. In other words, the utility enterprise must be viewed as a whole without regard to the separate corporate entities, and the rate of return should be the same for the entire utility enterprise.

[9] We see no reason to depart from our holding. A corporation should not be permitted to break up the utility enterprise by the use of affiliated corporations and thereby obtain an increased rate of return for its activities. In the light of the dominance of the Bell System and its integrated position, we again reject the view that a finding of the reasonableness or prudence of Pacific's purchases from Western would warrant termination of the Western Electric adjustment.

There has been no substantial change since our prior decision as to the dominance of the Bell System or as to the relationship between Pacific, American, and Western. Accordingly, Western must be considered part of the utility enterprise, and its prices should be adjusted to reflect no greater rate of return on its sales to Pacific than Pacific is entitled to earn on its operations. This result cannot be avoided on the basis of a finding that Western's prices were reasonable when compared to other manufacturing enterprises.

[10, 11] The increased rate of return permitted for Western activities may not be sustained on the record before us on the theory that it represents a reward for efficiency. When the commission sees fit to permit a reward for efficiency pursuant to section 456 of the Public Utilities Code (see fn. 7), it must specify the amount of the reward. If the commission, in permitting a reward, fails to specify the amount of the reward, it becomes impossible to review the decision of the commission. Thus, in the instant case, there is no way of separating out the amount of the increased rate of return permitted as a reward for efficiency and no way of determining what part of the increase is due to other factors. In addition, the ratepayers are entitled to know the amount of any rewards included in their rates since it is their money that is being used for the reward. When the commission determines to give away ratepayers' money, it must at

least tell the donors how much they are giving.

[11] NEW NONREVENUE PRODUCING CAPITAL EXPENDITURES

The commission followed its usual practice in calculating the rate base for the test year 1970 by using an average year rate base. However, the commission then adjusted the figure to reflect that $75 million of 1970 capital expenditures and $80 million of 1971 capital expenditures would be nonrevenue producing. The commission increased the rate base on the basis of those figures in arriving at a pro forma rate base. Also the commission adjusted the depreciation expense, ad valorem taxes, and income taxes.

An executive of Pacific testified that there would be discretionary investment in 1970 and 1971 in the above amounts. The discretionary items were identified as improvements in the service which apparently were not immediately necessary but would be necessary in the long run. The executive listed such items as replacement of older offices, centralized automatic call distributing systems, broad band restoration which permits quicker restoration of service when there is a wreck or fire, improvement of coin boxes so as to better withstand vandalism, undergrounding in residentisl areas, improved pressurization of cables, and new items of station equipment.

Although the witness did not identify these investments as nonrevenue producing investments but rather ss discretionary investments in the sense that they were not required by commission order or to maintain service, it seems apparent that most of the items would not be expected to produce sny substantial increase in revenues.

[12] The commission's categorization ol nonrevenue producing investment is probably a misnomer; the investments are an important part of the revenue producing system, and it would seem more appropriate to term the investments as investments which will not *increase* revenues rather than nonrevenue producing. With this qualification, the evidence is sufficient to support the commission's finding as to the *amount* of *expenditure* for "nonrevenue" improvements, and the contention that the evidence is insufficient must be rejected.

It is also claimed that the findings of the commission are insufficient to justify the adjustment of the rate base and expenses. The commission stated: "In Exhibits Nos. 75 and 102, Pacific includes alternative 1970 results of operation using a weighted average rate base and a year-end rate base. Pacific contends that the use of a year-end pro forma rate base is justified in this proceeding to offset the erosion of rate of return which is the inevitable effect of inflation. Pacific points out that the Commission lfrequently has made an allowance in rate of return to take care of anticipated attrition in earnings which results primarily from inflation.

"We do not agree that the use of a year-end rate base necessarily is appropriate. For example, If all of the capital additions installed by a utility during the year are directly related to providing service to new customers, the additionsl net revenues to be received from those new customers normally should also be reflected in the test year if a year-end rate base Is to be used. On the other hand, we often have utilized a rate base which was higher than either a weighted average or a year-end rate base when installation of non-revenue-producing plant is imminent. In such cases, the additional plant would be completed before or soon after the new utility rates became effective. Not only would there be no offsetting additional net revenues available to offset the higher investment, there would be additional expenses. Unless the non-revenue-producing plant and related depreciation expense and taxes were 'rolled back' into the test year, the utility would never achieve the rste of return found reasonable by the Commission.

"To determine the rate of return for the test year 1970 for rate-making purposes we will consider how much additional non-revenue-producing plant will hsve been in-

stalled by the approximate midpoint of the first 12 months that the new telephone rates have been in effect. Undisputed testimony of Pacific's vice president in charge of operations shows that about 75 million dollars of 1970 capital expenditures and 80 million dollars of 1971 capital expenditures are essentially non-revenue-producing. Only about half of those 1970 expenditures and none of the 1971 expenditures would be reflected in a weighted average 1970 rate base and corresponding net revenue. When we 'roll back' into the 1970 test year all such non-revenue-producing plant that will have been installed by the end of 1971, including the effect of additional depreciation expense and additional ad valorem taxes, offset in part by lower income taxes which result from the higher assumed expenses and bond interest, the end result should be reasonably close to the return which will be realized by Pacific during the first 12-month period that the new telephone rates are in effect."

[13] The basic approach of the commission in rate making, as pointed out at the beginning of this opinion, is to take a test year and determine the revenues, expenses, and investment for the test year. We pointed out in Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 645, 44 Cal.Rptr. 1, 7, 401 P.2d 353, 359, that the test period results are adjusted to allow for reasonably anticipated changes in revenues, expenses, or other conditions "so that the test-period results of operations as determined by the commission will be as [1307] nearly representative of future conditions as possible." Within this rule, the commission may adjust all figures, revenue, expense, and investment for anticipated changes but it may not adjust one side or part of the equation without adjusting the other unless there is a finding that the particular expenditure is extraordinary. This was recognized by the commission when it pointed out that it would not be proper to change from a weighted average rate base to a year-end rate base without also adjusting revenues to reflect new customers.

[14] In the instant case, the commission did not find that the investment which would not increase revenue was extraordinary in comparison to past practice. To the contrary, the commission reasoned that the investment must always be "'rolled back'" into the test year. The commission reasoned that unless the adjustment was made Pacific would never achieve the reasonable rate of return. This is only true if the increased revenues expected in the future will not be sufficient to offset this investment and other increased investment and expenses. But there is no finding that the anticipated increase in revenues will not offset all of the increased investment and expenses. In the absence of a finding that the investment which would not increase revenue is extraordinary or that the anticipated increase in revenue will not be sufficient to offset all anticipated increases in expenses and investment, there is no basis for adjusting the test year figures.

Under the findings made, we have no way of knowing whether the discretionary investment should be considered large in comparison to prior years when viewed either as to dollars to be spent or in relation to total investment. It may be that in comparison to prior years, the $75 or $80 million figures are not large because similar amounts were spent on discretionary investment in prior years. The $75 and $80 million figures represent approximately 10 percent of the anticipated total of all investments to be made by Pacific in 1970 and 1971, and it may well be that more than 10 percent of the rate base for the test year was based on discretionary investment. If so, it would seem that any adjustments to be made should be made in the direction opposite to that followed by the commission. In any event, any adjustment to be made should be made only for that portion of the investment which may be deemed extraordinary. Since there is no finding that the investment which will not produce increased revenues is extraordinary or that the anticipated increased revenues for future years are insufficient

to offset anticipated increased expenses and investment, the findings are insufficient to support the adjustment.

[15] Pacific argues that the adjustment is warranted to offset the effects of inflation. But the two matters are essentially unrelated. Discretionary expenditures may increase or decrease without regard to whether there is inflation or deflation. Moreover, the commission did not rely on the inflation argument.

RATE OF RETURN

[16] The commission fixed the permissible rate of return at 7.85 percent (with 9.5 percent on common equity) which was a substantial increase over the prior rate order. From 1948 to 1954 the authorized rate was 5.6 percent, in 1954 it became 6.25 percent, in 1958 it became 6.75 percent and in 1964 it was reduced to 6.3 percent. (Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 643–644, 44 Cal.Rptr. 1, 401 P.2d 353.) In 1968, the rate of return was 6.9 percent.

In the last cited case, we concluded that the rate of return there involved was "within the bounds of reasonableness" and would not be disturbed. (62 Cal.2d at p. 656, 44 Cal.Rptr. 1, 401 P.2d 353.) The return allowed in the instant case was within the range of the commission's staff recommendation, was only slightly above that urged by petitioner cities, and was within the range of reasonableness. The matters considered by the commission in fixing the rate of return were of the same nature as those considered in the last cited case, and we are satisfied that the commission did not abuse its discretion in fixing the rate of return.

LICENSING CONTRACT SERVICES

Pacific's parent, American, provides certain services such as basic research, assistance in engineering, legal, accounting, financing and other matters for the Bell System operating companies, of which Pacific is one, where these services can be performed more efficiently and effectively on a centralized basis. The amount Pacific pays to American for these services is computed by taking an amount equal to 1 percent of Pacific's gross revenue.

Historically, the commission has rejected the amount computed on the percentage-of-revenue basis when determining Pacific's reasonable expenses for the purpose of setting rates.[9] In lieu of the percentage-of-revenue computation, the commission has used for rate setting purposes the actual costs to American for services rendered to Pacific. The licensing contract expense allowed in the instant case was computed in this manner. However, use of the actual cost figures resulted in a higher allowance than the actual payments made to American.

[17] We pointed out earlier in connection with the discussion of the Western Electric adjustment that in the light of the dominance of the Bell System and its integrated position, the utility enterprise must be viewed as a whole without regard to separate corporate entities. In accordance with this fundamental principle, the commission properly decided to use the actual costs of the services rendered by American rather than the amount paid by Pacific to American.

LIFELINE SERVICE

The "lifeline service" is a basic minimum service which was previously offered at the rate of $2.25 per month with a message allowance of 30 units. This rate was the same, irrespective of whether one or two-party service was used. The service is offered in those areas where residential message rate service is available, with the only restriction being that no more than

9. The percentage-of-revenue basis of payment was rejected because although over a period of years it might result in average charges that were reasonable, the end result in any particular year at a particular level of rates might not be reasonable. For example, a 10 percent increase in Pacific's rates would result in a 10 percent increase in payments to American for exactly the same services.

one such service is allowable per dwelling unit.

[18] Pacific requested that the basic charge for this service be increased to $2.95 and that the 30-message units allowance be reduced to zero. The commission authorized the increase in basic charge to $2.95, but only allowed the message unit allowance to be reduced to 20. This is said to amount to a 52 percent increase in cost to "lifeline" subscribers.[10]

Neither Pacific nor the commission have cited us to any evidence in the record to support this extraordinary increase in cost of the lifeline service,[11] and our review of the record has failed to disclose any such evidence. The extraordinary increase in cost of the lifeline service cannot be sustained on the record before us.

LONG TERM CONSTRUCTION PLANS

The commission ordered Pacific to install $750 million of plant additions for each of the years 1971, 1972, and 1973. The finding supporting this order stated that plant additions of at least $750 million per year by Pacific for the next three years would decrease the likelihood of service problems. This finding was based on evidence in the record which included an analysis of Pacific's 1970 construction expenditures and estimates, as to both size and necessity, and of the construction expenditures anticipated for the next few years. One of the exhibits described in detail the manner in which Pacific arrived at its estimates of future construction expenditures. The commission staff also made their own estimates which closely matched those of Pacific.

Under section 761 of the Public Utilities Code, the commission is authorized after a hearing and a finding that the ". . . practices, equipment, appliances, facilities, or service of any public utility . . . are unjust, unreasonable, unsafe, improper, inadequate, or insufficient, . . ." to order ". . . practices, equipment, appliances, facilities, [or] service, . . ." to be used by the regulated utility. Section 762 of the Public Utilities Code authorizes the commission to order changes after a hearing and finding that ". . . additions, extensions, repairs, or improvements to, or changes in, the existing plant . . . or other physical property of any public utility . . . ought reasonably to be made, or that new structures should be erected, to promote the security or convenience of . . . the public, or in any other way *to secure adequate service or facilities*, . . ." (Italics added.)

[19, 20] It is contended that the instant order was outside the authority of either section 761 or 762 because the sections do not specifically authorize the commission to make a general order to expend a gross dollar amount, rather than ordering construction of a particular facility. The intent of these sections is to allow the commission to insure that the utility can and will provide adequate service. Such a broad intent can support a general order as was issued in the instant case.

10. Although the increase from $2.25 to $2.95 is 31.1 percent, the *actual cost* should be calculated by not only figuring the increase in the basic rate, but also calculating the *loss in value* of the service, namely the loss of 10 units of the message allowance, or one-third of the lifeline value. On this basis, the actual percentage increase for lifeline users is claimed to be 52 percent.

11. Pacific cited pages 5575–5577 of the transcript as evidence that the lifeline service requires an initial capital investment of between $25 to $50 per customer. This testimony was in response to the question whether a lifeline system could be established in Sacramento. In cities where such service has already been instituted, the capital investments have already been made and cannot be the basis for requiring an increased rate. No cost statistics were offered by which the commission could determine the reasonableness of the proposed rate increase. In its answer, Pacific asserts that the cost of providing lifeline service greatly exceeds the revenue produced thereby but fails to point to any evidence in the record to sustain this assertion.

Moreover, Pacific concedes that the commission has the power to review the specific expenditures made from this gross amount and to disallow as an expense any which it considered unjustified or wasteful. Such review alone satisfies petitioners' objection to the order.

[21] It is also contended that the order is based on an insufficient finding. The commission's finding that the addition of $750 million per year would decrease the likelihood of service problems is sufficiently specific to satisfy the requirements of section 1705 of the Public Utilities Code.

[1361] [22] In addition it is urged that the commission ignored important opposition testimony by a certain witness. The commission did not ignore this testimony. On the contrary, the opinion explained in detail the commission's reasons for rejecting the testimony. When conflicting evidence is presented from which conflicting inferences can be drawn, the commission's findings are final. (Southern Pac. Co. v. Public Utilities Com., 41 Cal.2d 354, 362, 260 P.2d 70.)

ADVERTISING EXPENSES

The commission allowed Pacific to include $11.5 million spent on advertising as an operating expense. The actual advertising expenditures attributable to California were approximately $12.9 million. The commission disallowed $1.4 million on the recommendation of its staff on the ground that there was serious doubt as to whether all the actual advertising expense related to "informative" as opposed to "institutional" advertising.

[23] It is contended that since Pacific is a monopoly with captive consumers, any advertising except that of informing the public of emergency services is calculated to and does no more than create a good public image, and as such is institutional advertising which is not allowable as an operating expense. Advertising which is properly classified as informative results in more than a mere fostering of goodwill. It should result in reductions in operating costs and more efficient service to the ratepayer. The commission could properly conclude that expenditures for such purposes are reasonable operating expenses, and in the absence of a showing that the amount allowed for informative advertising was primarily directed for other purposes, the allowance of the commission must be upheld.

MISCELLANEOUS CHARGES

After individual consideration of the majority of items affecting the rate proposal, the commission dealt with those which remained under the heading of "Other Miscellaneous Charges." Most of the items in this category involved rate and installation charges for numerous equipment and service functions. All of the items are identified in exhibit f1, section 3, which explains that each such charge is supported by recent cost studies. These cost studies were provided to the commission staff for review and one such study was introduced as evidence.

The commission determined that the rate changes requested merely recognized the ". . . rising costs of the offerings, . . ." and that since most of the proposed rates involved less than a 25 percent increase, they should be approved.[12] In its [1368] findings and conclusions, the commission stated, "[b]ased upon the record herein, the increases in rates and charges authorized herein are justified; the rates and charges authorized herein are reasonable; and the present rates and charges, insofar as they differ from those prescribed herein, are for the future unjust and unreasonable."

[24] It is contended that the commission's finding that these increases were justified and reasonable is inadequate.

12. Of the rates included in the miscellaneous list, 72 percent involved increases of 25 percent or less. The other 28 percent (four items) involved increases ranging from 200 percent to 900 percent.

The finding on which these increases were based not only enumerated the commission's reasons for allowing the increase, but was supported by substantial evidence which was before the commission. The contention is therefore without merit.

MOTION TO QUASH SERVICE

On March 2, 1971, petitioner Bennett was issued three subpoenas to compel the attendance of Pacific's president and two other corporate officers at public hearings involving telephone rate increases. The return date on the subpoenas was March 17, 1971, at 9:30 a. m. The subpoenas were left with an employee of Pacific, who was designated to accept service of process on the corporation, on March 16, 1971.

The commission held that the subpoenas had not been properly served and ordered them quashed, thus denying petitioners an opportunity to examine the corporate officials. Petitioner Bennett argues that such a holding constitutes a denial of due process of law.

[25] Section 1987 of the Code of Civil Procedure provides that except in the case of a peace officer: "(a) . . . the service of a subpoena is made by delivering a copy . . . to the witness *personally* . . . [or] [¶] (b) In the case . . . of a party . . . or of anyone who is an officer, director, or managing agent of any such party . . . the service of a subpoena upon any such witness is not required if written notice requesting such witness to attend before a court, or at a trial of an issue therein, with the time and place thereof, is served upon the attorney of such party or person. Such notice shall be *served at least 10 days before the time required for attendance* unless the court prescribes a shorter time." (Italics added.)

Petitioner Bennett delayed serving the subpoenas for 14 days until the eve of the return date, and the commission did not abuse its discretion in quashing the subpoenas on the grounds that they had not been properly served.

PROPRIETY OF COMMISSION MEETING

[26] Following the issuance by the Public Utilities Commission of the instant decision on June 22, 1971, petitioner Bennett requested a rehearing. This initial petition for rehearing was denied on June 29, 1971, and an amended petition for rehearing was filed on July 2, 1971. The amended petition, under provisions of the law, stayed the effective date of the rate increase. On Sunday, July 4, 1971, three of the commissioners came together at an airport near Concord, California, and denied the amended petition. Petitioner Bennett contends that such a meeting was in excess of the commission's jurisdiction.

Section 306 of the Public Utilities Code directs the commission to ". . . meet at such . . . times and in such . . . places as may be expedient and necessary for the proper performance of its duties, . . ." Petitioner has not asserted that Concord, California, was not an expedient meeting place, nor that July 4, 1971, was not a necessary time. Petitioner's innuendos of misconduct, absent specific allegations, are an insufficient basis for review of the meeting's propriety.

ANNULMENT OF THE COMMISSION'S ORDER

[27, 28] As we have seen, the portions of the commission's decision dealing with the federal and state tax expense, the Western Electric adjustment, and the new "nonrevenue producing" capital expenditures cannot be sustained on the record before us. Although the exact amount of money involved in these portions of the decision is not clear from the record, it is clear from the record that the amount is substantial in relation to the $143 million annual rate increase, and it is possible that the amount involved in the enumerated items is equal to or exceeds the amount of

the increase.[13] No basis appears to sever these matters from the increase of rates [1]56 ordered by the commission, and it is not claimed that severance is possible. Pacific urges that the increased rates should be continued in effect until the commission establishes a new rate, but there is no basis to continue a rate once it is determined that the rate is invalid. We conclude that the commission's order increasing rates must be annulled in its entirety. This would ordinarily mean that the prior lawfully adopted rate would then go into effect.

On April 4, 1972, the commission by Decision No. 79873 authorized new telephone rates which provided for an increase in rates totalling approximately $70 million annually. This increase includes in it the $143 million increase before us. The April 4 increase was not based on a full scale rate proceeding; rather the commission used the figures and results used in the proceeding before us, using the same test year, and merely adjusted to offset higher operating expenses due to changes in the wages paid, tax law changes, and changes in some other items. On the basis of these changes the commission granted the increase in rates so that the anticipated revenues would produce the rate of return found reasonable in the instant proceeding.

The decision of April 4 is not before us, and although the rates fixed in that proceeding are obviously based in part upon the erroneous determinations in the proceeding before us, we cannot annul in this proceeding the April 4 decision.

Nevertheless, we must recognize that the April 4 rates will supersede the rates in the decision before us, that the errors in the instant proceedings would require annulment of the April 4 decision should it come before us on review unless appropriate action is taken, and that unless this court acts to effectuate our decision the errors we have found will merely be carried forward into future rate increases.

We conclude that to avoid this result this court should order the commission to reinstate the rates of its last lawful order preceding the instant rate proceeding, provided, however, that it may grant interim rate increases upon appropriate findings (see Saunby v. Railroad Commission, 191 Cal. 226, 230 et seq., 215 P. 904; Decision No. 42530, 48 Cal.P.U.C. 487, 488; cf. Dyke Water Co. v. Public Utilities Com., 56 Cal.2d 105, 110, 14 Cal.Rptr. 310, 363 P.2d 326), while it considers the propriety of the application for rate increase before us. Such a provision will permit the commission to grant immediate relief to Pacific if appropriate and should prevent the invalid determinations of the commission in the instant proceedings from continuing to affect future rates.

REFUNDS [1]56

At the request of petitioners and with the consent of Pacific, we have previously

13. With respect to the federal and state taxes, the Western Electric adjustment, and the so-called nonrevenue capital expenditures, the relevant figures in the instant case relating to the effect of the departure from accounting principles used in the 1968 rate proceeding are unclear and in some respects conflicting. Nevertheless, some of those figures which seem reliable indicate that more than half of the $143 million increase in the revenue requirement is attributable to the accounting changes which cannot be sustained on the record before us. There is also a strong indication that more than $143 million is accounted for when the amount of revenue increase necessitated by these accounting changes is added to the amount of revenue increase attributable to the change in the rate of return, which in a sense is also an accounting adjustment. In other words, there is reason to believe, although it is not entirely clear, that there has been no substantial changes in the relationship between revenue and expenses since the 1968 rate proceedings involving Pacific, and that none of the rate increase was necessitated by changes in the actual revenue and expenses of Pacific, but that the entire increase may be attributable to the change in the accounting principles and evaluations applied by the commission in determining rates.

issued a partial stay providing that all sums collected by Pacific pursuant to the rates authorized by the decision under review shall be subject to refund in whole or in part upon order of this court should the decision or Decision No. 77984 of the commission be annulled or modified.

Petitioners claim that upon annulment of the decision before us the rate increase will be determined to be invalid, that all sums collected in excess of the last lawful rate will have been illegally collected, and that all such sums must be refunded. Pacific urges that this court defer determination of refunds. Pacific's position is that the case should be remanded to the commission to set a new lawful rate in the light of our opinion, and that the refunds should be limited to the difference, if any, between the rates set in the decision before us and the rates set in the further proceedings. Pacific's argument was made in a brief filed before the April 4 decision and it should be pointed out that in the circumstances of this case the rates contemplated by Pacific to be set in further proceedings to determine the amount of refund are artificial rates, and will never go into effect except for the purpose of determining refunds because new rates to be established by the commission for the future will no doubt take into account the matters which led to the April 4 increase in rates. It would obviously be inappropriate to consider such matters in determining the amount of refund in the instant case.

The statutes dealing with stay of commission rate changes pending review by this court do not expressly deal with the question of refunds where there has been a stay and the rate increase is subsequently annulled. The statutes authorizing stays, sections 1762–1764 of the Public Utilities Code, merely provide for the stays and the posting of bonds or the impounding of funds without dealing with the situation before us. In other situations, the Legislature has more clearly spelled out the rights of the parties. Thus, where a commission order *reducing* rates is stayed, or where a commission order denying a rate increase is stayed, and the utility is permitted to charge the proposed higher rates pending review, the statute provides expressly for refunds if the commission order is ultimately affirmed. (Pub.Util. Code, §§ 1764, 1766; cf. Market St. Ry. Co. v. Railroad Commission, 28 Cal.2d 363, 368, 171 P.2d 875.) The absence of any provision for refunds should a commission order be annulled for any reason apparently establishes that no refund will be permitted for annulment of a rate decrease irrespective of the reasons for annulment. The latter situation, the annulment of a rate *decrease*, is of course the converse of the situation before us, the annulment of a rate *increase*, and this suggests that full refunds are in order where a rate increase is annulled.

We are confronted with a similar question in Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 649–656, 44 Cal.Rptr. 1, 401 P.2d 353. In that case the commission determined that Pacific should reduce its rates by more than $40 million annually. The commission also ordered that Pacific refund to its customers amounts collected from its customers in excess of the new rates during the nearly two years while the rate investigation had been pending before the commission. The amount of the refund ordered was approximately $80 million. Although we affirmed the decision of the commission insofar as it reduced future rates, we annulled the portion of the decision which required the refund. We concluded after an extended review of the relevant statutes that the Legislature had given the commission power to establish rates prospectively and has not given it power to order refunds of amounts collected by a public utility pursuant to an approved order which has become final.

[29] We pointed out that the fixing of a rate is prospective in its application and legislative in its character, that under section 728 of the Public Utilities Code, as well as other sections of the code, the commission is given power to prescribe rates prospectively only, and that the commission could not, even on grounds of unreasonableness, require refunds of charges fixed

by formal finding which had become final. (62 Cal.2d at pp. 650–655, 44 Cal.Rptr. 1, 401 P.2d 353.) We recognized that there may be policy arguments for giving power to the commission to order refunds retroactively where rates are found to be unreasonable or to prevent unjust enrichment, but we concluded that such "arguments should be addressed to the Legislature, from whence the commission's authority derives, rather than to this court." (62 Cal.2d at p. 655, 44 Cal.Rptr. at p. 14, 401 P.2d at p. 366.) The Legislature has not changed any of the relevant statutory provisions.

We pointed out that the conclusion that the Legislature has not authorized retroactive rate making was supported by section 734 of the Public Utilities Code. (62 Cal.2d at pp. 654–655, 44 Cal.Rptr. 1, 401 P.2d 353.) That section provides that when a rate has been formally found reasonable by the commission, the commission shall not order the payment of reparation upon the ground of unreasonableness. Of course, the rates existing prior to the present proceeding have been found reasonable by a final commission decision.

[30] When the rates set in the decision before us are annulled, the only lawful rates are those which were in existence prior to the instant decision. We are satisfied that to permit the commission to fix new rates for the purpose of refunds, as requested by Pacific, would involve retro-
1297 active rate making in violation of the principles recognized in Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 649–656, 44 Cal.Rptr. 1, 401 P.2d 353. The basic conclusion that the rates existing prior to this proceeding are unreasonable as well as the conclusion that increases in rates are justified are both based on the same defective findings. To permit the commission to redetermine whether the preexisting rates were unreasonable as of the date of its order and to establish new rates for the purpose of refunds would mean that the commission is establishing rates retroactively rather than prospectively. As we have seen, the Legislature has expressly prohibited the granting of reparations on the basis of unreasonableness, where, as here, there is an approved rate, and the Legislature has authorized only prospective rate making.

Although there may be substantial policy reasons to permit retroactive rate making, there are also substantial reasons to the contrary, and it is for the Legislature to determine whether California should abandon its policy against retroactive rate making.

The adoption of a comprehensive scheme of public utility rate regulation involves numerous considerations, and it has been recognized that absolute equity must sometimes give way to the greater overall good, including the demands of certainty and efficiency. (See Keco Industries v. Cincinnati & Suburban Bell Tel. Co., 166 Ohio St. 254, 141 N.E.2d 465, 469.) The Ohio Supreme Court in *Keco* rejected the view urged by Pacific that the refunds should be the difference between the invalid rate and the future rates ultimately adopted by the regulatory agency. It pointed out that, although there may not be absolute equity in every circumstance, the Legislature has attempted to keep the equities between consumer and utility in balance and that departures from the absolute equity position based on policy considerations could work in favor of either. This seems reflected by the recent history of the telephone rates in our state. In Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 649–656, 44 Cal.Rptr. 1, 401 P.2d 353, we held that the commission, in the light of the rule against retroactive rate making, could not compel Pacific to refund $80 million although we did not dispute the commission's findings that a sum of that magnitude was collected in excess of what would have been a reasonable rate. Today, in furtherance of the same rule, we must compel Pacific to refund a similar or perhaps larger amount.

In the light of the rule against retroactive rate making, it cannot be said on the

record before us that inequity will result from a refund of the entire increase of rates collected pursuant to the invalid order. The record does not demonstrate that the increased rates are necessitated by changes since the 1968 rate proceeding in
1368 the relationship of revenue and expense of the utility. To the contrary, there is a strong indication that the entire rate increase is due to changes in accounting principles and accounting evaluations made by the commission. (See fn. 13.) Under the rule against retroactive rate making changes in the rates due to changes in accounting practices and accounting evaluations should only be given effect prospectively after such changes are made on a proper record. As pointed out in Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 656, 44 Cal.Rptr. 1, 14, 401 P.2d 353, 366, it "is the 'just, reasonable, or sufficient *rates*' (italics added) which section 728 directs the commission to fix after it first finds that 'the rates . . . charged, or collected . . . are unreasonable.'" The accounting changes in the instant case are essential to the finding of unreasonableness.

The cases of United States v. Morgan, 307 U.S. 183, 59 S.Ct. 795, 83 L.Ed. 1211, and Atlantic Coast Line v. Florida, 295 U. S. 301, 55 S.Ct. 713, 79 L.Ed. 1451, relied upon by Pacific, are distinguishable. In those cases, the earlier rate which was to be superseded by the administrative agency's invalid rate change was not fixed by the agency and found to be reasonable after hearings as was done in the case before us. We recognized that prior approval of the administrative agency might be a decisive consideration in Pacific Tel. & Tel. Co. v. Public Util. Com., *supra*, 62 Cal.2d 634, 653, 44 Cal.Rptr. 1, 401 P.2d 353, where we distinguished a case on this basis. Moreover, *Morgan* and *Atlantic Coast Line* are of doubtful validity in the light of the later decision in Chicago, M., St. P. & P. R. Co. v. Illinois, 355 U.S. 300, 302, fn. 2, 78 S.Ct. 304, 2 L.Ed.2d 292, wherein the district court had required that funds due to the rate increase be impounded and paid to the ratepayers in the event the administrative order was annulled. Although the United States Supreme Court merely noted and did not discuss the validity of the refund order in its opinion upholding the annulment of the rate increase, the question seems to have been squarely presented on a subsequent application for supersedeas. The court then denied the application without opinion, but a five-page dissenting opinion was filed urging the court to follow *Morgan* and *Atlantic Coast Line*. (356 U.S. at pp. 906–910, 78 S.Ct. 665, 2 L.Ed.2d 573.)[14]

1335 We conclude that the entire increase of rates collected pursuant to the invalid order must be refunded. We are informed that the rates approved in the April 4 decision, as amended, went into effect on May 27, 1972. As we have seen, the April 4 increase of rates includes the invalid increase before us, and the latest increase was not based on a full scale rate proceeding but rather merely adjusted the rates before us to offset certain changes in operating expenses. Insofar as the rates which went into effect on May 27 reflect increases based on the invalid order before us, refunds are necessary. However, insofar as the May 27 rates are attributable to the approximately $70 million increase author-

14. In Thermoid Western Co. v. Union Pacific Railroad Co., 12 Utah 2d 256, 365 P.2d 65, like the *Morgan*, *Atlantic Coast Line*, and *Chicago* cases, the earlier rate which was to be superseded by the invalid rate change was not fixed by the agency after hearings, and thus the case is distinguishable. Moreover, the majority in following *Morgan* and *Atlantic Coast Line* stated that, had the funds from the invalid rate increase been impounded, a different result might have been reached. (365 P.2d at p. 70.) Of course, in the instant case our partial stay was, in effect, an order requiring the increases in rates to be impounded.

The other three state cases cited by Pacific deal with the problem of refunds without any substantial discussion of the problem, and none of the cases cited by Pacific consider in this connection the policy against retroactive rate making.

ized on April 4, they are not subject to refund at this time.

The decision is annulled. The commission is directed to reinstate the rates of its last lawful order preceding the instant rate proceeding provided, however, that it may grant interim rate increases should it find them appropriate while it reconsiders Pacific's application for rate increases. The commission is further directed to order Pacific to make refunds in accordance with the views expressed herein.

WRIGHT, C. J., and McCOMB, TOBRINER, BURKE, and SCHAUER,* JJ., concur.

CONCURRING AND DISSENTING OPINION BY MOSK, J.

MOSK, Justice (concurring and dissenting).

I concur with the majority opinion except for its approval of the commission's authorization for Pacific to include $11.5 million spent on advertising as an operating expense.

By way of introduction I point out that several years ago Pacific attempted to include in operating expenses all the dues it paid to chambers of commerce and the contributions it made to charities. In decision No. 67369 the commission disallowed over half of that amount, observing that "Dues, donations and contributions, if included as an expense for rate-making purposes, become an involuntary levy on ratepayers, who, because of the monopolistic nature of utility service, are unable to obtain service from another source and thereby avoid such a levy." The commission then ruled that *all* such expenses would be disallowed in the future, and we held this to be "the correct rule." (Pacific Tel. & Tel. Co. v. Public Util. Com. (1965) 62 Cal.2d 634, 668–669, 44 Cal.Rptr. 1, 22, 401 P.2d 353, 374; see also *id.* at pp. 676–677, 44 Cal.Rptr. at p. 22, 401 P.2d at p. 374 (concurring opn. of Mosk, J.).)

By the same token I believe that in the present proceeding the commission should have eliminated all of Pacific's claimed advertising costs in its calculation of operating expenses for rate-making purposes. Advertising is generally designed to create goodwill. I submit that the cost of promoting company goodwill should come out of the pockets of stockholders rather than ratepayers. My conclusion in 1965 regarding voluntary contributions applies equally well here: "A dissatisfied stockholder may seek to change the policies of a corporation, defeat the directors, or sell his stock investment. No comparable alternatives are available to a monopoly ratepayer, whose only choice is to pay the full bill sent to him—for services rendered and gifts made in the name of the company—or abandon the use of his telephone." (Pacific Tel. & Tel. Co. v. Public Util. Com., supra, at p. 677, 44 Cal.Rptr. at p. 27, 401 P.2d at p. 379 (concurring opn.).)

The advertising of the utility falls into two categories. The first, service informative advertising, according to testimony before the commission, is designed "to inform, advise, instruct and solicit the cooperation of telephone users in making the most efficient use of the telephone. Subjects covered include: direct distance dialing and area codes; directory assistance calls; use and posting of emergency numbers; correction of billing; promotion of goodwill through 'we're here to help' campaign; advice on how to handle malicious, obscene or harassing calls; repair service; buried cable; open house, and public service."

Public instruction which is deemed necessary to proper use of telephone facilities can adequately be provided in the informational pages of the annual telephone directory. By definition, the item for "promotion of goodwill through 'we're here to help' campaign" is calculated merely to

* Retired Associate Justice of the Supreme Court sitting under assignment by the Chairman of the Judicial Council.

foster goodwill. And advice on how to handle obscene telephone calls is properly a function of law enforcement agencies. Thus I would eliminate all the costs attributable to the first category.

The second category, service promotional advertising, according to testimony before the commission, is designed "to stimulate the use of revenue-producing attachments, extensions, etc., or to stimulate long distance calling." This type of advertising is also suspect.

I find it incongruous that the utility should be encouraged to expend sums for advertising to stimulate the public to make telephone calls at the very time it is seeking substantial funds for new equipment because of the overtaxing of present facilities. Nor can I justify promotion of sales of attachments, extensions and similar devices, many of which are more decorative than functional, as an essential item of operating expense chargeable to ratepayers. Such cost should be added to the charge for the device itself, but not constitute a levy upon ratepayers generally.

[1a] In the abstract sense, of course, the judiciary is not well placed to reexamine each and every item of accounting that has heretofore been considered by the staff and members of the regulatory commission. On the other hand, the staff member who testified on the subject of advertising at the commission hearing conceded that "A review was made of the types of advertising used but *no in-depth study was made as to the cost vs. benefits of such advertising.*" (Italics added.) I would refuse consideration of all advertising expenses for rate-making purposes, at least until such time as an appropriate in-depth analysis has been made.

While $11.5 million may not be a substantial percentage of the total operating expenses of this vast public utility, nevertheless it is not a trivial sum when expended by a corporation which operates as a monopoly bearing the imprimatur of the state. It is obviously a highly visible use of the ratepayers' money, and appears to stir up considerable public resentment. The commission's decision itself recognizes that "The item of Pacific's expenses which was subject to the most criticism of public witnesses is advertising." I can only conclude that the commission should have paid greater heed to the sensitivity of the public it is created to serve.

497 P.2d 807
7 Cal.3d 362

In re Chad Marriit SMITH on Habeas Corpus. [1a]

Cr. 15986.

Supreme Court of California, In Bank.

June 13, 1972.

Habeas corpus proceeding by petitioner who was under constructive restraint of probation following conviction of indecent exposure. The Supreme Court, Mosk, J., held that in absence of additional conduct intentionally directing attention to his genitals for sexual purposes, petitioner who simply sunbathed in the nude on isolated beach did not "lewdly" expose his private parts, within meaning of statute proscribing indecent exposure, and was thus entitled to habeas corpus relief.

Writ granted.

1. Obscenity ⇐3

Separate requirement, in statute proscribing indecent exposure, that intent of actor be "lewd" is an essential element of the offense. West's Ann.Pen.Code, § 314, subd. 1.

See publication Words and Phrases for other judicial constructions and definitions.

2. Obscenity ⇐3

Conviction of indecent exposure requires proof beyond a reasonable doubt that actor not only meant to expose him-

1009; see *People v. Hood* (1969) 1 Cal.3d 444, 458, 82 Cal.Rptr. 618, 462 P.2d 370.) Counsel's alleged failure to assert the defense thus was not error.

[4] Finally, defendant argues the sentence for assault with a deadly weapon constitutes cruel or unusual punishment. We recently answered a similar contention in *People v. Wingo* (1975) 14 Cal.3d 169, 121 Cal.Rptr. 97, 534 P.2d 1001.

The judgment is reversed on count I (burglary) and affirmed on count II (assault with a deadly weapon).

WRIGHT, C. J., and McCOMB, TOBRINER, SULLIVAN, CLARK and RICHARDSON, JJ., concur.

542 P.2d 1371

15 Cal.3d 680

[1] CITY OF LOS ANGELES et al., Petitioners,

v.

PUBLIC UTILITIES COMMISSION et al., Respondents;

PACIFIC TELEPHONE AND TELEGRAPH COMPANY, Real Party in Interest.

CITY OF LOS ANGELES et al., Petitioners,

v.

PUBLIC UTILITIES COMMISSION et al., Respondents;

GENERAL TELEPHONE COMPANY OF CALIFORNIA, Real Party in Interest.

S. F. 23215, S. F. 23237 and S. F. 23257.

Supreme Court of California, In Bank.

Dec. 12, 1975.

Appeals were taken from decisions of the Public Utility Commission approving telephone tariffs. The Supreme Court, Tobriner, J., held, inter alia, that the public utilities commission had both statutory and constitutional authority to approve tariffs which would annually adjust telephone rates to take account of changing federal tax expenses of telephone companies taking advantage of accelerated depreciation under the Internal Revenue Code.

Affirmed in part and remanded in part.

1. Public Service Commissions ⇐11

Public Utilities Commission may and should consider sua sponte every element of public interest affected by utility proposals which it is called upon to approve, and it should not be necessary for any private party to rouse Commission to perform its duty. West's Ann.Public Util.Code, §§ 451, 454.

2. Statutes ⇐219(1)

Consistent administrative construction of statute over many years, particularly when it originated with those charged with putting the machinery into effect, is entitled to great weight and will not be overturned unless clearly erroneous.

3. Public Service Commissions ⇐7.3

Under Public Utilities Code section providing that the commission after hearing may adjust improper rates, classifications, rules, etc., commission is empowered to use annual adjustment clauses in determining rates. West's Ann.Public Util. Code, § 728.

4. Constitutional Law ⇐296(1)

Within the regulatory context, due process is a flexible concept permitting expert administrative agencies broad latitude in adapting the specific regulatory needs of their jurisdictions.

5. Constitutional Law ⇐298(1)

Agencies to which rate-making power has been delegated are free, within ambit of their statutory authority, to make pragmatic adjustments which may be called for by particular circumstances, and once a fair hearing has been held, proper findings made and other statutory requirements are satisfied, courts cannot intervene in absence of clear showing that limits of due process have been overstepped; if agency's

order, as applied to facts before it and viewed in its entirety, produces no arbitrary result court's inquiry is at an end.

6. Public Service Commissions ⇐17

Public Utilities Commission must hold a full hearing before promulgation of a general rate tariff. West's Ann.Public Util.Code, § 728.

7. Constitutional Law ⇐296(1)

Promulgation of an annual adjustment formula as part of a general utility tariff following a full hearing by Public Utility Commission comports with due process and the periodic application of the formula to the figures in the utility's books does not entail any denial of due process. West's Ann.Public Util.Code, § 728.

8. Public Service Commissions ⇐6.9, 17, 26

Public Utility Commission having established uniform accounting system may prescribe manner in which regulated utilities employ them after granting utilities an opportunity to be heard on the question, and the Commission's decision after such hearing is subject to both rehearing and to judicial review. West's Ann.Public Util.Code, §§ 791–794, 1731, 1756.

9. Constitutional Law ⇐296(1)

Insertion of numbers derived from accounting system adopted at one hearing by Public Utilities Commission into a formula approved at another hearing does not deny due process. West's Ann.Public Util.Code, § 728; U.S.C.A.Const. Amend. 14.

10. Telecommunications ⇐332

Public Utilities Commission after setting telephone company rates with provision for annual adjustment of rates to take amount of changing federal tax expense because of the accelerated depreciation under the Internal Revenue Code could permit utility to submit written briefs at the time of annual adjustment if it thought the procedure was useful, but the practice was not constitutionally mandated. West's Ann.Public Util.Code, § 1757; 26 U.S.C.A. (I.R.C.1954) §§ 46 et seq., 167.

11. Telecommunications ⇐313

Public Utility Commission in considering telephone rates had both constitutional and statutory authority to approve tariffs which would annually adjust telephone rates to take account of changing federal tax expenses because of the utilities' use of accelerated depreciation under the Internal Revenue Code, and the failure to consider such an approach was a failure by Commission regularly to pursue its authority. West's Ann.Public Util.Code, § 1757; 26 U.S.C.A. (I.R.C.1954) §§ 46 et seq., 167.

12. Public Service Commissions ⇐17

A rehearing, unlike a reopening of rate proceeding after decision has become final prevents an order previously made from becoming final. West's Ann.Public Util.Code, §§ 1708, 1736.

13. Telecommunications ⇐344

Where Public Utilities Commission reheard case of telephone company its order did not become final and it could promulgate an interim rate subject to refund. West's Ann.Public Util.Code, §§ 1708, 1736.

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[1a] [1] TOBRINER, Justice.

In these three telephone rate cases the Public Utilities Commission determined, *inter alia*, that it lacked legal authority to approve tariffs which would annually adjust telephone rates to take account of changing federal tax expenses. As a consequence, the commission found itself compelled to set a rate which, in its own words, would "create a windfall for [the telephone companies] to the detriment of the ratepayers." (Re Pacific Telephone & Telegraph Co. (1974) Cal.P.U.C. (Decision No. 83162; slip opn., p. 63).) The commission took this action in spite of our having annulled its previous decisions in this matter "[f]or failure to consider lawful alternatives in calculation of federal income tax expense." (*City & County of San Francisco v. Public Utilities Commission* (1971) 6 Cal.3d 119, 130, 98 Cal.Rptr. 286, 292, 490 P.2d 798, 804.) As we explain, we have concluded that the commission does possess the power to implement an annual adjustment scheme, and we accordingly remand these cases in order that the agency may reconsider its action with knowledge of the full scope of its powers.

In addition to this failure to consider lawful alternatives in the treatment of tax expenses, the petitioning cities assert as grounds for annulment: (1) that the commission authorized an unreasonably high rate of return for the two telephone companies in question; and (2) that the commission erred in promulgating an interim rate pending its rehearing of the General Telephone case. As to the first contention, we have concluded that the commission did not exceed the boundaries of its discretion. (Pub.Util.Code, § 1757.) As to the second contention, we show below that the commission regularly pursued its authority.

1. *The background of the present litigation.*

Because these cases spring from the relationship between federal taxing authority and public regulatory power, we must review pertinent developments in these two fields.

[1b] [1] An extremely significant element of the operating expenses which a rate-setting agency must consider is that of state and federal taxes;[1] increased tax deductions decrease a utility's tax bill and with it the revenue it must acquire from its ratepayers. These cases turn on two such tax deductions available to General and Pacific,[2] accelerated depreciation and the Job Development Investment Credit;[3] both of them enable a public utility to reduce its tax expenses, and the efforts of regulatory bodies to pass the benefits of such reduced tax expenses on to the utilities' ratepayers form the backdrop to the instant cases.[4]

Such regulatory efforts are of course mandatory for a state agency charged with insuring that "[a]ll charges demanded or received by any public utility . . . shall be just and reasonable" (Pub.Util. Code, § 451) and that "[n]o public utility shall raise any rate . . . except upon a showing before the commission and a finding by the commission that such increase is justified" (Pub.Util.Code, § 454).

1. According to one authority, as of 1967 United States telephone companies spent 23 percent of their total revenue on taxes. (Welch, Cases, Text, and Material on Public Utility Regulation (rev. ed. 1968) p. 440.)

2. We refer in this opinion to the real parties in interest in the instant case, General Telephone Company of California and Pacific Telephone and Telegraph Company, as General and Pacific, respectively.

3. The Job Development Investment Credit (85 Stat. 503, 26 U.S.C. § 46 et seq.), a tax deduction which all parties concede has tax and revenue effects substantially similar to accelerated depreciation and therefore calls for identical treatment, will be included in all subsequent references to accelerated depreciation.

4. In the instant Pacific proceeding the commission indicated that for *1973 alone* "the difference in gross revenue requirements between" a rate passing tax benefits on to the consumer and one permitting the utilities to retain these benefits "is approximately $23 million." (Re Pacific Telephone & Telegraph (1974) Cal.P.U.C. (Decision No. 83162, slip opn., p. 71).)

We therefore examine the background of these cases to determine whether the commission has failed to consider alternative means of dealing with unnecessary tax payments which might be eliminated to the benefit of the ratepayers.

Since 1954, section 167 of the Internal Revenue Code has given business taxpayers several options in computing depreciation deductions from their federal taxes. Thus the utilities in the instant case may, like other businesses, assume that their depreciable assets wear out at an even rate and deduct the same amount of depreciation for each year of useful life; such an assumption is known as "straight-line" depreciation. Another option, first made available by 1954 amendments to the Internal Revenue Code is "accelerated" depreciation (Int.Rev.Code of 1954, § 167(b)(2)–(4)); using this method the enterprise takes deductions as if the asset in question depreciates more rapidly in the earlier years of its life and more slowly thereafter.[5] A taxpaying utility using accelerated depreciation would deduct the same *total* amount of depreciation over the useful life of the asset as a taxpayer using straight-line methods, but accelerated depreciation permits the largest part of this total to be deducted in the early years of the asset's life.

If one thinks of a single piece of depreciable equipment, such as a desk or typewriter, over the long run it would make no difference which system of depreciation were employed since the utility could write off no more than the total value of the asset in any case. That which holds true for a single asset, however, does not do so for an enterprise considered as an evolving whole. (Bonbright, Principles of Public Utility Rates (1961) pp. 218–223; see *Alabama-Tennessee Natural Gas Co. v. Federal Power Comm'n* (5th Cir. 1966) 359 F.2d 318, 328.)

Ratemakers have discovered that if the total enterprise is either expanding or stable, the use of *accelerated depreciation does not merely defer taxes, but eliminates them entirely.* (See *F.P.C. v. Memphis Light, Gas and Water Div.* (1972) 411 U.S. 458, 460, 93 S.Ct. 1723, 36 L.Ed.2d 426; Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation under Section 167* (1956) 69 Harv.L.Rev. 1096, 1102.) This effect occurs because in the later years of an asset's life (when its value as a depreciation deduction has been used up), its place is taken by a *new piece of equipment, which replaces it as a deduction in income tax calculation.* This replacement effect means that the higher depreciation taken in early years does not have to be paid for by lower depreciation in later years; *the tax never catches up.* The result is a net tax savings to any utility using accelerated depreciation.[6]

5. In fact, the code and Treasury Regulations permit several different forms of accelerated depreciation, the differences between which are not here relevant; *all* forms of accelerated depreciation result in a deduction larger than that permitted by straight-line methods in the earlier years of the asset's life.

6. A respected federal appellate judge has explained the apparently paradoxical tax savings as follows: "Lifetime depreciation on a single item of property is of course the same whether the utility elects straightline or accelerated depreciation. Under conventional accounting principles, therefore, the full amount of the value of the item less salvage would be a deductible expense. Conventional accounting, however, does not take into consideration the effect of applying liberalized depreciation to a utility's total assets which are, of course, subject to a continuing cycle of obsolescence and renewal. If the industry is stable or expanding, requiring the utility's *continued reinvestment in plant equal to or in excess of plant retirement*, a program of liberalized depreciation produces true tax savings because there is no reduction in the tax reserve fund [fn. omitted]." (*Alabama-Tennessee Natural Gas Co. v. Federal Power Comm'n, supra*, 359 F.2d 318, 328 (Wisdom, J.); emphasis in original.)

The United States Supreme Court has explained that the effect described by Judge Wisdom occurs because "the depreciation allowances from additional and replacement equipment offset the declining depreciation allowance on existing property." (*Federal Power Comm'n. v. Memphis Light, Gas and Water Div., supra*, 411 U.S. 458, 460, 93

[687] For a rate-setting agency the comprehension of this counter-intuitive fact has important implications. If the Public Utilities Commission in setting rates were to assume that tax deductions for depreciation under both the straight-line and accelerated methods would yield the same result in the long run, it would, in fact, award the utility a rate windfall. For it would have set rates as if the utility would incur tax expenses *which it would never have to pay*.

In 1960 the California Public Utilities Commission after studying this problem issued a report indicating that it would pass on to ratepayers any savings effected by the adoption of accelerated depreciation and suggesting that the utilities' managements elect this method. (Commission Investigation Regarding Rate Fixing Treatment for Accelerated Amortization and Depreciation for all Utilities, 57 Cal.P.U.C. 598.) [7]

Pursuant to this recommendation "[a]pparently *all utilities other than Pacific and General Telephone* have used accelerated depreciation." (*City and County of San Francisco v. Public Utilities Commission, supra*, 6 Cal.3d 119, 124, 98 Cal.Rptr. 286, 288, 490 P.2d 798, 800; emphasis added.) Because "Pacific and General Telephone, unlike other utilities . . . refused to use accelerated depreciation . . . [o]n November 6, 1968, in Decision No. 74917 the Commission determined that Pacific's management was imprudent" in not electing the option and "concluded that for purposes of rate making Pacific would be treated as if it had obtained the tax saving of accelerated depreciation and that the saving would be [passed on] . . . to the consumers in the form of lower rates. (Imputed accelerated depreciation with flow-through.)" (*Id.*) [8]

[688] In 1969, however, Congress amended the Internal Revenue Code.[9] The amendments, some of a highly technical nature, provided that utilities which had not taken accelerated depreciation before 1969 could do so subsequently only if they "compute[d] their cost of service, which includes federal income taxes, as if they were using straight-line depreciation. This method, referred to as 'normalization,'[10a] was 'de-

S.Ct. 1723, 1725, 36 L.Ed.2d 426; see also Note, *The Effect on Public-Utility Rate Making of Liberalized Tax Depreciation under Section 167* (1956) 69 Harv.L.Rev. 1096, 1102.)

7. Economists recognize that accelerated depreciation, when combined with flow-through accounting, encourages timely replacement of needed capital equipment (Deffiese, *Changing Accounting Objectives—What About Utilities?* (1972 No. 2) 90 Pub.Util.Fort. 17, 20–21) in the extremely capital-intensive public utility industry (Rudolph, *Depreciation and Changing Price Levels: Specific Problems of Utilities*, in Depreciation and Taxes (Tax Inst. edit. 1959) pp. 80, 80–81) and permits obsolescence to be recognized before rather than after the fact "so that consumers will reap the benefits of progress that much sooner." (Deffiese, *supra*, at p. 21.)

8. The commission's ruling corresponded with the conclusion reached by Swiren, *Accelerated Depreciation Tax Benefits in Utility Rate Making* (1961) 28 U.Chi.L.Rev. 620, 632: "The public interest requires that utilities maintain their costs at the lowest level consistent with proper service to the consumer. Accordingly, if the flow-through theory is sound and the reduction in current taxes is a permanent saving, *utilities should be required to utilize that procedure.*" (Emphasis added.)

9. Internal Revenue Code of 1954, section 167(*l*), as amended December 30, 1969; see *City and County of San Francisco v. Public Utilities Commission, supra*, 6 Cal.3d 119, 125, 98 Cal.Rptr. 286, 490 P.2d 798.

10. Internal Revenue Code of 1954, section 167(*l*)(3)(G), as amended December 30, 1969. As we explained in *City and County of San Francisco v. Public Utilities Commission, supra*, 6 Cal.3d 119, 128, 98 Cal.Rptr. 286, 291, 490 P.2d 798, 803: "Although the majority opinion [of the commission] ignores this matter, the concurring opinion and the two dissenting opinions [of the commission] recognize that accelerated depreciation and normalization will result in the ratepayers contributing capital to Pacific. As the concurring opinion points out, this method of accounting will 'provide a source of interest-free capital.' We do not know how much capital will be provided, but the dissenting commissioners estimate

signed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation. If a utility used accelerated depreciation in determining its actual tax liability, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes was required to be placed in a deferred tax reserve account. See *Amere Gas Utilities Co.*, 15 F.P.C. 760." (*F.P.C. v. Memphis Light, Gas & Water Div., supra*, 411 U.S. 458, 460, 93 S.Ct. 1723, 1725, 36 L.Ed.2d 426.) After the passage of these laws Pacific and General reversed their longstanding opposition to accelerated depreciation and began to take the larger deductions it authorized; they contended, however, that if the commission passed on to the ratepayers any of the savings thereby achieved, "degradation of service and possible financial collapse" would result and the utilities would "go bankrupt."[11]

In the wake of these developments a divided Public Utilities Commission decided that it "could not continue the existing method of *imputing* accelerated depreciation" to the utilities (*City & County of San Francisco v. Public Utilities Com.*, *supra*, 6 Cal.3d 119, 125, 98 Cal.Rptr. 286, 289, 490 P.2d 798, 801; emphasis added) and therefore that " 'it would now be futile to consider' " other methods benefitting the ratepayer because normalization was the only available alternative. (*Id.*, at p. 126, 98 Cal.Rptr. 289.) We annulled.

In a unanimous opinion we held that the commission had not regularly pursued its authority in failing "to consider lawful alternatives in calculation of federal income tax expense." (*Id.*, at p. 130, 98 Cal.Rptr. 292.) Specifically, we ruled that the commission should consider alternatives, which, while taking into account "the imprudent management"[13] of the real party in interest, might serve as "a compromise striking a proper balance between the interests of the ratepayers and . . . [real party in interest] in the light of current federal income tax statutes." (*Ibid.*) The instant case arises from the commission's action on remand.[13]

Following our annulment of its decisions in *City and County of San Francisco* and *City of Las Angeles*, the commission held new hearings. In the case of Pacific we had annulled a final rate,[14] and the commission therefore held entirely new ratemaking proceedings, considering each aspect of revenue and expenses anew. General's case involved an additional factor; as we set forth in the margin, the commis-

that the ratepayers in the next 10 years will have to provide between $750,000,000 and one billion dollars."

11. The commission rejected these contentions abstaining from passing the tax benefits of accelerated depreciation on to the ratepayers only because of its doubts about its legal power to do so.

12. In the case from which we quote, the phrase referred exclusively to Pacific, but, as we have subsequently pointed out, it might apply equally to General: "Apparently, all the utilities in California except Pacific and General Telephone follow accelerated depreciation with flow through . . . . Pacific and General Telephone have apparently in the past used straight line depreciation." (*City of Los Angeles v. Public Utilities Commission* (1972) 7 Cal. 3d 331, 338–339, fn. 2, 102 Cal.Rptr. 313, 319, 497 P.2d 785, 791; cf. Re General Telephone Co. of Cal. (1974) Cal.P.U.C. (Decision No. 83778, pp. 23, 39).)

13. Because we held that the commission's failure to consider lawful alternatives in tax treatment was error, and because we subsequently found that this and other errors could not be severed from the remainder of the rate, we annulled the entire Pacific rate. (*City of Los Angeles v. Public Utilities Commission* (1972) 7 Cal.3d 331, 102 Cal.Rptr. 313, 497 P.2d 785.) As noted below (fn. 15, *infra*) the commission, perceiving that the Pacific and General cases involved identical legal issues, reheard the General case. Thus, although strictly speaking, "remand" was involved only in the Pacific case, the commission reconsidered both cases, and we now have before us the results of that reconsideration.

14. See *City of Los Angeles v. Public Utilities Commission*, *supra*, 7 Cal.3d 331, 354–359, 102 Cal.Rptr. 313, 497 P.2d 785.

sion considered appropriate ratemaking treatment of tax expenses for General in two separate proceedings, once in a limited rehearing of a rate case contemporaneous with the annulled Pacific decision,[16] and once in hearings held pursuant to a new rate increase request by General.[16] Because all three of these proceedings reached substantially identical treatments of the tax expenses in question by a substantially identical procedural route, we shall describe them as a single proceeding, noting divergences only when necessary.[17]

The commission focused most of its attention on a staff proposal somewhat awkwardly styled "pro forma normalization." Stated briefly, this proposal involves an accounting adjustment which takes account of the fact that the deferred tax reserve (an asset) is much lower at the start of the ratemaking period than it will be after the effects of accelerated depreciation accumulate.[18] The staff plan called for a reduction in the rate base (on which return is calculated) to reflect what is, in effect, an additional source of revenue for the utilities.[18] The commission, however, rejected pro forma normalization on the grounds that it would violate the provisions of the Internal Revenue Code and of a Treasury Regulation interpreting it.[20]

15. At the time we filed *City and County of Los Angeles v. Public Utilities Commission*, *supra*, 6 Cal.3d 119, 98 Cal.Rptr. 286, 490 P.2d 798, the commission had just granted General a rate increase based in part upon the same treatment of accelerated depreciation which we found unlawful in *City of Los Angeles* and *City of San Francisco*. (Re General Telephone Co. of Cal. (1971) 72 Cal.P.U.C. 652.) Recognizing that the same legal issue controlled both the Pacific and General rates, the commission in response to petitions by the Cities of Los Angeles and Long Beach granted rehearing. (*Re General Telephone Co. of Cal.* (1971) 72 Cal.P.U.C. 725; *Re General Telephone Co. of Cal.* (1972) 72 Cal.P.U.C. 795.) These orders continued in effect the rates promulgated before *City of Los Angeles* was filed, but made them subject to refund if the commission subsequently found them unjustified. (We consider *infra* at pp. 790–798 of 125 Cal.Rptr., pp. 1388–1390 of 542 P.2d, the propriety of the interim order and the rates established by it.)

16. *Re General Telephone Company of Cal.* (1975) Cal.P.U.C. (Decision No. 83779).

17. The commission's most elaborate and most complete response to the problem and to our order on annulment occurs in its decision in the Pacific case (Decision No. 83162). While considerable discussion is devoted to the topic in the limited rehearing of the General case (Decision No. 83778), the commission staff had at the time of hearing of that matter not yet fully developed its alternative proposals. The two General cases (Decisions Nos. 83778 and 83779) were filed after the Pacific proceeding and rely heavily on it; the Pacific decision (No. 83162) thus becomes the key commission response.

18. As we have noted, the crucial fact about this deferred tax reserve is that it is a misnomer; unlike other deferred reserves, this one represents not a putting-aside for expenses which will later be encountered, but a *permanent savings*. (See fn. 6, *supra*, and text thereto.) Moreover, the utility can earn interest on this reserve and, unless some adjustment is made, will earn a return from ratepayers on it.

19. In order to effect this adjustment without running afoul of the new Internal Revenue Code restrictions, the staff proposed to hold the rate of return "even," but to decrease the *rate base*. Pro forma normalization accomplishes this result by substituting for the deferred tax reserve of the *historical* test year which the commission uses to set rates, a figure based on projections of *future* accumulations of this reserve.

20. While the commission's proceedings in the instant cases were pending the Treasury promulgated a series of regulations which in the commission's view, precluded pro forma normalization. (Treas.Reg. § 1–167(*l*)–1(A)(6) (1974).) We here reiterate that in view of our disposition of these cases, we express no opinion regarding the validity of the regulation as an interpretation of section 167 of the Internal Revenue Code of 1954 (cf. Arkansas-Oklahoma Gas Co. v. Commissioner of Int. Rev. (8th Cir. 1953) 201 F.2d 98, 102; Mertens, The Law of Federal Income Taxation (rev. ed. 1974) § 3.21, p. 40), the constitutionality of the regulation as an infringement of the powers reserved to the states under the federal Constitution (U.S.Const., Amend. X), or the continued availability of pro forma normalization (cf. fn. 42, *infra*).

With its attention thus concentrated on the primary staff proposal and Pacific's and General's vigorous objections to it, the [551] commission gave only cursory consideration to another proposal, known as "annual adjustment."[21] The record indicates that the hearing examiner suggested to the parties that the feasibility of a system of yearly automatic rate adjustment be investigated. The staff witness accordingly prepared exhibits and testified at some length concerning this rate setting system.[22]

While technical in its application, the concept of an annual adjustment is essentially simple: the rate established by the commission includes a formula which, when applied each year to figures in the utilities' accounts, produces appropriate adjustments in rates to keep them in step with the company's changing financial situation.[23] In the case of annual adjustment to reflect the growing deferred tax reserves, the *actual* amount of the reserve accumulated by the utility would be compared with the amount used in the test year on the basis of which the commission set rates.[24] As the reserve grew, the formula would effect a corresponding reduction in the rate base to take account of this new source of investment capital.

The effect of annual adjustment in some respects resembles that which would occur if the commission each year conducted a new rate proceeding in which all factors except that of tax reserve held constant. In such a case the commission would look [551] to the tax reserve as the sole relevant variable and reduce the rate base to compensate for tax reserve accumulations. As long as the commission's policy towards the tax reserve accumulations remained unchanged, however, such yearly proceedings would reduce themselves to substantially ministerial steps.[25] In similar circumstances the commission has concluded that the promulgation and periodic application of an adjustment formula more efficiently implements its policy.

The commission thus employs adjustment clauses when it encounters an item of ex-

21. The commission devoted a scant ten lines to its discussion of annual adjustment in its original decision in the Pacific case (Decision No. 83162) and supplemented this consideration with but three additional sentences on denial of rehearing (Decision No. 83540). Mention of this opinion on denial of rehearing makes it appropriate to indicate at this point that the commission neither violated the statutes governing its procedures nor trespassed on its discretion in supplementing its opinion upon denial of rehearing. (Pub.Util.Code, §§ 1708, 1730.) Petitioners' contentions to the contrary are meritless.

22. At the request of Hearing Examiner Barnett the staff witness developed the requested information. Their testimony and cross-examination by various parties covers more than 50 pages of reporter's transcript. In addition they submitted some 20 supplemental pages of explanation in the form of exhibits.

23. For more than three years, subsidiaries of the Bell System providing telephone service in Illinois, New Jersey, and Canada have *sought* "automatic" adjustment clauses to enhance utility productivity and compensate for price and cost fluctuations (Kendrick, *Efficiency Incentives and Cost Factors in Public Utility Automatic Revenue Adjustment Clauses* (1975) 6 Bell J.Econ. 299, 304–309 [hereafter cited as Kendrick]).

24. In fact, the staff witness suggested two forms of annual adjustment. In one, known as January 1st adjustment, the commission would employ the estimates of tax reserves on the company's books at year end to make its adjustment; in the other form, the commission would wait until the following October, at which point the final figures would be in, before making the adjustment. The disadvantage of the October method flows from the nine-month lag in rate relief, a lag whose effect is cumulative; the advantage of the October clause is that it is based on final figures ascertainable after the company's books have been audited. We perceive no statutory or constitutional significance to flow from the difference between these two methods, and what we say below applies equally to both of them.

25. As in the case of "automatic" adjustment clauses for productivity and price fluctuations (Kendrick, *supra*, at pp. 308–309), the regulatory commission's primary function should be to gather empirical data periodically on changes in each utility's tax reserve accumulations and then apply relevant data to the adjustment formula.

pense or revenue which tends to vary abnormally in comparison to the utility's other financial data; fuel cost adjustment clauses, which the commission presently inserts in the tariffs of power companies, constitute a prominent current use of such clauses. The commission's staff experts testified that the rapidly accumulating tax reserves presented an anomalous factor in the telephone companies' financial profile similar to that posed by the fuel costs of the power companies.[26]

The commission accepted this analysis, explaining that: "One consequence of the use of accelerated depreciation by Pacific is to create a rapidly growing reserve for deferred taxes that is totally out of consonance with the roughly harmonious relationship between revenues, expenses, and rate base." (*Re Pacific Telephone* (1974) Pac.P.U.C. Decision No. 83162, slip opn. 63); accord, *Re General Telephone Company of California* (1974) Cal.P.U.C. (Decision No. 83778, slip opn., p. 24).)

In spite of the applicability of the usual justifications for annual adjustment clauses to the instant cases, however, the com-
1493 mission without consideration rejected its staff's recommendation that such clauses be made a part of the tariff in the event flowthrough and pro forma normalization were rejected.[27] The commission explained its refusal to consider annual adjustment clauses in the following terms: "Nor will we consider further the automatic adjustment clause. This method was proposed with the understanding that the commission would consider it only if Pacific consented to its imposition; Pacific has not consented." (*Re Pacific Telephone and Telegraph Company* (1974) Cal.P.U.C. (Decision No. 81362, slip opn. p. 59).)

Elaborating on this somewhat cryptic statement[28] in its opinion on denial of rehearing, the commission indicated that its refusal to consider annual adjustment stemmed from its belief that "Any order which would have the effect of automatically reducing the rates of any utility without hearing and without the opportunity for hearing would be inconsistent with the Public Utilities Code unless the consent of the utility was first obtained. Our rejection of the automatic reduction method stems not from any undue consideration for Pacific but from a due regard for statutory limitations."[29] (*Re Pacific Tele-*

26. In the words of the staff witness who explained the mechanics of annual adjustment: "As I have testified and demonstrated both in an earlier phase of this proceeding and in the reopened proceeding of General Telephone Company . . ., the growth of the deferred tax reserve *far exceeds the normal growths of revenue, expenses, and rate bases, which tend to grow proportionately.* . . . The rates of most California utilities are set on the basis that revenues, expenses, and rate base will grow somewhat in *proportion* and these same utilities have no tax reserve as they are on flow through. For a normalization company like Pacific, the rate base *cannot grow as fast as it normally would* because the deferred tax reserve is displacing investment which would come from stock or bondholders for a straight line or flow through company." (Emphasis added.)

27. The staff witness indicated that annual adjustment ranked just behind pro forma normalization as a desirable alternative to normalization, which was the plan proposed by the utilities.

28. Neither the real parties nor the commission has indicated the origin of the "understanding" to which the decision refers; any such understanding would in any case be irrelevant in light of our order on annulment to consider "alternative approaches" to the problem which accelerated depreciation posed for ratemakers. (City & County of San Francisco, *supra*, 6 Cal.3d 119, 130, 98 Cal.Rptr. 286, 490 P.2d 798.) Parties may not by consent disregard directions of this court.

29. In so ruling the commission seemingly assumed that annual adjustment conformed to Internal Revenue Code of 1954 section 167, subdivision (*l*)(3)(F) and Treasury Regulation, section 1-167(*l*). Since the instant cases, of course, do not squarely present the question of the congruence of accrual adjustment and the Internal Revenue Code, we do not address the issue. We note in passing that in concept, annual adjustment closely approximates annual ratemaking, and the Internal Revenue Code does not, of course, forbid such a procedure. (See Treas. Reg. § 1-167(*l*)-1(h)(6)(ii).)

phone and Telegraph Company (1974) Cal.P.U.C. (Decision No. 83540, slip opn. p. 10).) We must therefore examine the legal bases of the commission's refusal to entertain the system proffered by its staff.

2. *The Public Utilities Commission failed regularly to pursue its authority in refusing to consider annual adjustment as an alternative rate setting system.*

The commission in these cases operated under a dual obligation to weigh and explain its actions in regard to the treatment 1104 of accelerated depreciation. First, it acted, as always under the statutory obligations of insuring that all utility rates are just and reasonable (Pub.Util.Code, § 451), that no utility raises its rates unless the commission finds the increase justified (Pub. Util.Code, § 454), and that its decision "contain[s], separately stated, findings of fact and conclusions of law . . . on all issues material to the order or decision" (Pub.Util.Code, § 1705).[30]

In addition to these continuing statutory duties, the commission in the instant case was also bound by our order in *City and County of San Fancisco v. Public Utilities Commission, supra,* 6 Cal.3d 119, 98 Cal. Rptr. 286, 490 P.2d 798, in which we annulled a tariff for the commission's "failure to consider lawful alternatives in calculation of federal income tax expense" (*id.*, at p. 130, 98 Cal.Rptr. at 292, 490 P.2d at 804), and in which we indicated that the commission should consider available alternatives. Thus the commission labored under a two-fold obligation thoroughly to deliberate upon methods of dealing with a problem it had perceived.

[1] In spite of these statutory and judicial obligations, however, the commission failed to consider an annual adjustment provision, a plan suggested by its hearing examiner, testified to by its staff, concerning which full cross-examination had occurred, and which, on the face of the record, appeared capable of relatively easy implementation. Speaking of a similar failure to consider relevant aspects of a decision, we recently explained "[t]he Commission may and should consider *sua sponte* every element of public interest affected by . . . . [utility proposals] which it is called upon to approve. It should not be necessary for any private party to rouse the Commission to perform its duty . . . .. Thus, we conclude that the Commission failed to give adequate consideration to the . . . issues . . . and that its decision must be annulled." (*Northern California Power Agency v. Public Util. Com.* (1971) 5 Cal. 3d 370, 380, 96 Cal.Rptr. 18, 25, 486 P.2d 1218; accord, *City & County of San Francisco v. Public Utilities Commission, supra,* 6 Cal.3d 119, 98 Cal.Rptr. 286, 490 P.2d 798; *City of Las Angeles v. Public Utilities Commission, supra,* 7 Cal.3d 331, 102 Cal.Rptr. 313, 497 P.2d 785.) If, as we have shown, unjustified failure to deliberate constitutes error, we must consider the grounds which the commission has proffered as justification of its refusal to consider annual adjustment. 1105

In explaining its action the commission indicated that discussion of an annual adjustment clause would serve no purpose because Public Utilities Code section 728, which requires a "hearing" before the pro-

30. As Justice Traynor emphasized in the leading case construing the requirement of specific findings, a requirement added to the statute in 1961: "Even when the scope of review is limited, . . . findings on material issues enable the reviewing court to determine whether the commission has acted arbitrarily. . . . Findings on material issues can also serve to help the commission avoid careless or arbitrary action. . . . There is no assurance that an administrative agency has made a reasoned analysis if it need state only the ultimate finding . . . ." (California Motor Transport Co. v. Public Utilities Com. (1963) 59 Cal.2d 270, 274–275, 28 Cal.Rptr. 868, 871, 379 P.2d 324, 327.)

mulgation of rates, placed beyond its power a tariff which would automatically reduce rates without such a hearing.[31]

(a) *The Public Utilities Code permits the use of annual adjustment clauses.*

Section 728 of the Public Utilities Code simply provides that the commission "after a hearing" may adjust improper "rates, classifications, rules, practices, or contracts"; on its face, then, nothing in the statute is inconsistent with the use of an annual adjustment clause.

The commission and the utilities, however, implicdly assert that the terms "rates" and "hearing" in section 728 have extremely restrictive meanings which bar adjustment clauses. Their position depends upon the conception that a "rate" is a single set of unvarying fixed charges, and that a "hearing" must occur before each variation in those charges. Neither contention withstands scrutiny.

[2,3] In the first place, longstanding commission practice in other areas refutes its position in these cases. As testimony in the instant proceedings revealed, the commission has for a number of years included fuel adjustment clauses in the tariffs of power companies on the grounds that the variation in their fuel costs is disproportionate to the variation in their other costs.[32] Thus the commission itself has long recognized adjustment clauses do not exceed its authority.

[4a] [4] "Consistent administrative construction of a statute over many years, particularly when it originated with those charged with putting the statutory machinery into effect, is entitled to great weight and will not be overturned unless clearly erroneous. (*Federal Trade Com. v. Mandel Brothers* [1959] 359 U.S. 385, 391, 79 S.Ct. 818, 3 L.Ed.2d 893 . . .; *United States v. American Trucking Assns.* [1940] 310 U.S. 534, 549, 60 S.Ct. 1059, 84 L.Ed. 1345 . . .; *United States v. Leslie Salt Co.* [1956] 350 U.S. 383, 396, 76 S.Ct. 416, 100 L.Ed. 441 . . .; *Great Northern Ry. Co. v. United States* [1942] 315 U.S. 262, 275–276, 62 S.Ct. 529, 86 L.Ed. 836 . . .; *Norwegian Nitrogen Products Co. v. United States* [1933] 288 U.S. 294, 315, 53 S.Ct. 350, 77 L.Ed. 796 . . .; *Maser v. Stein* [1954] 347 U.S. 201, 213, 74 S.Ct. 460, 98 L.Ed. 630 . . .; see 1 Davis, Administrative Law Treatise, § 5.-06, p. 324.)" (*DiGiorgio Fruit Corp. v. Dept. of Employment* (1961) 56 Cal.2d 54, 61–62, 13 Cal.Rptr. 663, 667, 362 P.2d 487, 491.) Moreover, in the instant case no party presents any valid reason for holding this longstanding administrative interpretation unlawful.

In the face of this authority, the commission and the real parties in interest simply argue that the fuel adjustment clauses which it employs as a standard practice supply no precedent for the use of annual adjustment clauses for tax reserves. They urge that such clauses characteristically *raise* utilities' rates (as they have during the recent inflationary period) and therefore supply no authority for a clause which is expected to *reduce* rates.[33] In our opin-

31. The relevant sentence of Public Utilities Code section 728 reads as follows: "Whenever the commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices, or contracts affecting such rates or classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

32. *Re Southern California Edison* (1941) 43 C.R.C. 733; *Re Southern California Gas Co.* (1958) 56 Cal.P.U.C. 158; *Re California Electric Power Co.* (1958) 56 Cal.P.U.C. 221; see *Re Pacific Gas & Electric Company* (1971) 71 Cal.P.U.C. 724, 758–759; cf. *Riverside Cement Co. v. Public Util. Com.* (1950), 35 Cal.2d 328, 217 P.2d 403.

33. During proceedings before the commission, Pacific raised the additional objection that

ion the objection is specious; the statutory language simply does not differentiate between the rate changes which increase rates and those which decrease rates.

Moreover, such consistent administrative practice accords with the conclusions of a sister court which, some 20 years ago, faced a question very similar to that which we now consider. In *Norfolk v. Virginia Electric etc. Co.* (1955), 197 Va. 505, 90 S.E.2d 140, the Virginia Supreme Court addressed the contention that an annual adjustment clause could not be inserted in the tariff of a utility because the new rate would take effect without the 30-day notice to the public required by the relevant statute.

[19] Rejecting this contention, the unanimous court wrote: "[The power of the Commission is not limited to the mere change of a particular rate that the public must pay for the service rendered by a public utility, but it has the power to change . . . any part of a filed schedule, rate, rule or regulation that in any manner affects the rates charged or to be charged. . . . '[R]ate schedules consist not merely of a list of rates in dollars and cents, but . . . they customarily include provisions that will in various ways affect the rates charged at the time of filing or to be charged thereafter.' [¶] The proposed escalator clause is nothing more or less than a fixed rule under which future rates to be charged the public are determined. It is simply the addition of a mathematical formula to the filed schedules of the Company . . . . [I]t is clear that notice is not required on each occasion there is a change in the ratepayers' bills, but that notice is required for every change in the filed schedules which are the underlying bases for the computation of those bills."

Finally, in addition to longstanding administrative interpretation and the judicial authority described above, the purpose behind the hearing requirement of section 728 demonstrates the permissibility of the annual adjustment scheme here at issue. The purpose of the hearing is to air the policy considerations behind various rate proposals and to establish controverted facts; as the commission's experience with fuel clauses has shown, a hearing serves no purpose when the only business at hand is the application of a mathematical formula to a figure definitively established by reference to the utilities' books. The legislative purpose behind section 728 is better served by a plenary consideration of the advantages and disadvantages of an annual adjustment clause than by a yearly charade attendant to its application.

(b) *The Constitution does not forbid the use of annual adjustment clauses.*

As noted, the commission and the real parties in interest additionally argue that because a tariff containing an automatic adjustment clause could result in a decreased rate which would take effect without a prior hearing attendant to a full rate proceeding, the resulting rate decrease would constitute a taking without due process, in violation of the Fourteenth Amendment of the United States Constitution. As we explain, however, this argument ignores the elaborate safeguards attending both the establishment of the accounting procedures which the utilities must use to produce the relevant figures

power company fuel adjustment clauses supplied no precedent for the use of a tax reserve clause because the commission derived it power to use fuel clauses from Public Utilities Code section 454, not section 728. Section 454, however, merely exempts rate increases established pursuant to adjustment clauses from the new requirement that certain classes of utilities enclose with their regular billings all notices of rate increase applications. Only *common carriers* are exempted *additionally* from the requirement of a hearing before rate increases (Pub.Util.Code, § 454, subd. (b)). Thus section 454 establishes no exemption from section 728 for fuel clause increases; if, therefore, hearings are required before all rate changes under section 728, they are also required for fuel clause changes. As we have shown, however, such hearings are not requisite when they have occurred as to the general tariff including such adjustment clauses.

and the full hearing which would accompany the establishment of the tariff containing the adjustment clause. As we shall show, under the governing authorities, these safeguards render the use of annual adjustment clauses entirely constitutional.

[4] Before discussing the specific objections to the adjustment clause, we review the constitutional standards which the United States Supreme Court has set forth for such rate proceedings. The court has long made it clear that within the regulatory context due process is a flexible concept, permitting expert administrative agencies broad latitude in adapting the specific regulatory needs of their jurisdictions.

[5] Thus, in sustaining the actions of a federal regulatory agency against the complaint of a utility that commission procedures in setting rates had deprived it of a hearing, the court set forth the relevant due process criteria: "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called fur by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." (*Federal Power Com'n v. Pipeline Co.* (1941) 315 U.S. 575, 586, 62 S.Ct. 736, 743, 86 L.Ed. 1037, 1049; accord, *R. R. Com'n v. Pacific Gas Co.* (1937) 302 U.S. 388, 58 S.Ct. 334, 82 L.Ed. 319; *West Ohio Gas Co. v. Public Utilities Com'n* (No. 1) (1934) 294 U.S. 63, 70, 55 S.Ct. 316, 79 L.Ed. 761; *Market Street Ry. Co. v. Commission* (1945) 324 U.S. 548, 562, 65 S.Ct. 770, 89 L.Ed. 1171; see *Norwegian Nitrogen Co. v. U. S.* (1933) 288 U.S. 294, 317, 319, 53 S.Ct. 350, 77 L.Ed. 796.)

With these precepts in mind, we consider the utilities' contention that the use of an annual adjustment formula exceeds constitutional bounds because it fails to provide the utilities with a prior hearing before each annual adjustment of rates occurs. As we explain, however, contrary to the utilities' assertions, procedural safeguards mark every stage of the adoption of the annual adjustment formula.

[6, 7] As we have already shown, the commission must hold a full hearing before the promulgation of a general rate tariff. (Pub.Util.Code, § 728.) At such a hearing, the company has the opportunity through testimony, briefs, exhibits, and oral argument to inspect and challenge any formula proposed. (Pub.Util.Code, § 1705; Cal.Admin.Code, tit. 20, §§ 52, 59-61, 64, 68-70, 75-76.) The utility may at that hearing raise its objections either to the general concept of an adjustment clause or to the particular one proposed. It can point to states of fact on which the formula might yield an unjust or undesirable result and suggest corrective modifications. Indeed Pacific, at whose hearing annual adjustment was most fully developed, in fact took advantage of most of the procedural rights just enumerated. Under the circumstances, the promulgation of an annual adjustment formula as part of a general utility tariff obviously comports with due process; it remains therefore only to consider if the periodic application of the formula to the figures in the utility's books entails any denial of due process.

[8, 9] The adjustment clause would operate upon figures which the utilities had placed in their account books in accordance with the system of accounts as to which the companies had received another, prior hearing. (Pub.Util.Code, §§ 792, 794.)[34]

34. Empowered by law to "establish a system of accounts to be kept by the public utilities subject to its jurisdiction" (Pub.Util.Code, § 792), the commission has, when appropri-

The utility, of course, would have made the entries with the full knowledge that the commission would employ them in connection with the annual adjustment clause.[36] Having thus obtained the appropriate figures from the utilities' accounts (cf. Pub. Util.Code, § 791), the commission would proceed to apply them to the formula as to which the utility would have enjoyed ample opportunity to make its objections known at a full hearing. (Pub.Util.Code, § 728; Cal.Admin.Code, tit. 20, §§ 51–88.) The [1706] insertion of numbers derived[36] from an accounting system adopted at one hearing, into a formula approved at another hearing does not deny due process; the Fourteenth Amendment to the United States Constitution does not prohibit arithmetic.

Our holding accords with the authorities. Most closely in point is the decision of the Virginia Supreme Court, which faced, in addition to the statutory issues discussed above, a claim by ratepayers that a fuel adjustment clause would deprive them of due process because it did not afford them notice and hearing as to each of its applications; the court rejected the claim.[37] (*Norfolk v. Virginia Electric, etc. Co., supra*, 197 Va. 505, 90 S.E.2d 140.)

In so holding, the Virginia court spoke to the issue before us; after pointing to the widespread adoption of such clauses and their survival of legal challenges, it succinctly refuted the claim that their application constituted a denial of due process: "The City next contends that the escalator clause results in a denial of procedural due process of law to the consumers because there is no public notice and hearing on each occasion when the actual rate is increased . . . In the instant case there was sufficient notice to the public that the Commission would hold a formal hearing on the application of the Company to determine whether it was just and reasonable to insert the escalator clause into its filed schedules. The City appeared and participated in the proceedings and after an investigation by the Commission and a full hearing, the Commission found as a fact that the proposed escalator clause was 'just and reasonable,' a finding which the record does not warrant us in reversing. Consequently, the requirements of procedural due process have been fulfilled in this case. (See, e. g., *Railroad Commission of State of California v. Pacific Gas & Elec. Co.* [1938] 302 U.S. 388, 58 S.Ct.

ate, held hearings on the establishment of such uniform accounts. (*See In re Uniform System of Accounts* (1948) 48 Cal.P.U.C. 253; First Supplemental Order (1957) 55 Cal. P.U.C. 668; cf. Pub.Util.Code, § 793; 64 Cal.P.U.C. 27; 70 Cal.P.U.C. 470.) Having established such accounting systems, the commission may prescribe the manner in which the regulated utilities employ them, but only after granting the utilities an opportunity to be heard on this question. Public Utilities Code section 794 provides that: "[t]he commission may, *after notice, and hearing* if requested within 15 days after receipt of notice, prescribe by order the accounts in which particular outlays and receipts shall be entered, charged or credited." (Emphasis added.) The commission's decision after such a hearing is of course subject both to rehearing and to judicial review. (Pub.Util.Code, §§ 1731, 1756.)

35. Such figures might fluctuate both already incurred tax expenses and the utilities' own estimates of future tax expenses. The staff member testifying most extensively as to the annual adjustment method indicated that it might be desirable to confirm the figures for tax expenses with those reported to the utility's stockholders under the reports required by the federal Securities and Exchange Commission.

36. As in the case of fuel clauses, the commission may find it necessary to make minor adjustments in the raw figures derived from the utilities' books before applying them to the annual adjustment clause. In light of the protections attending the development and use of the clause, we perceive no constitutional significance to flow from this practice.

37. The court in considering the ratepayers' claims assumed that they stood entitled to due process in connection with any increase in their rates; the utilities in the instant cases can therefore derive little comfort from the circumstance that the customer rather than the utility raised the due process claim.

334, 82 L.Ed. 319 . . . ; *Ohio Bell Telephone Co. v. Public Utilities Comm.* [1937] 301 U.S. 292, 57 S.Ct. 724, 81 L.Ed. 1093 . . .)" (*Norfolk v. Virginia Electric, etc. Co., supra*, 197 Va. 505, 518, 90 S.E.2d 140, 149.)

Norfolk thus stands for the proposition that due process requires adequate hearings at the significant point of the adoption of the adjustment clause, rather than at the relatively unimportant occasions of its application. Measured by this standard, the system of annual adjustments proposed by the hearing examiner and the commission staff would offend no tenet of due process.

[701] This conclusion finds additional support in cases which have addressed the question whether due process requires that agencies afford regulated entities a hearing before acting on the basis of figures or data supplied to the agency by the utility itself. The question is relevant to the instant case, because the annual adjustment clause would operate upon figures entered by the utilities upon its own books. The utilities claim that due process entitles them to a hearing prior to the use of such figures; the authorities do not support this contention.

In a leading case a unanimous United States Supreme Court rejected the contentions of a California utility that the commission had denied it due process by using, as its rate base, the figure for which the utility had offered to sell itself to the city in which it was located. (*Market Street Railway Co. v. Comm'n.*, 324 U.S. 548, 65 S.Ct. 770, 89 L.Ed. 1171.) The railway argued that the use of this figure, which had found its way into evidence incidentally, and which the commission had not indicated it would use to fix the utility's value, denied it due process absent an opportunity to present argument concerning the accuracy and interpretation of the figure. The Supreme Court found the argument without merit; Justice Jackson, writing for the court, noted that the figure in question had been admitted into evidence without limitation as to use: "Doubtless the decision and the grounds of decision were unexpected. But surprise is not necessarily want of due process." (*Id.*, at p. 558, 65 S.Ct. 770 at p. 776.

Nothing in the operation of the annual adjustment clause as here proposed even approaches the procedure which generated the utility's complaint in *Market Street Railway*; unlike the railway, the telephone companies would at all times know the use to which the commission intended to put the tax reserve figures and would have an ample opportunity to make known their views of such proposed use.[38] (See *American Toll Bridge Co. v. Railroad Com.* (1938) 12 Cal.2d 184, 203–204, 83 P.2d 1.)

As further demonstration of the annual adjustment clause's impregnability to constitutional attack, we briefly contrast its operation with regulatory procedures [705] which have *failed* to survive judicial scrutiny under the due process clause. The utilities insist that these cases pose an insuperable constitutional barrier to the use of an annual adjustment clause; we shall show, however, that they are in fact entirely distinguishable. In *Ohio Bell Tel. Co. v. Comm'n.*, *supra*, 301 U.S. 292, 57 S.Ct. 724, 81 L.Ed. 1093, the commission had, without informing the utility of its intention to do so, taken judicial notice of a general decline in the prices of property and then adjusted downward the values of particular utility properties, all without

38. In a case similar to *Market Street Railway*, an Emergency Court of Appeals rejected a claim by a manufacturer subject to the authority of the Office of Price Administration. The administrator, in fixing the price on regular building blocks sold by the manufacturer, had calculated the manufacturer's cost by subtracting from a figure previously supplied by the plaintiff for blocks with special features the sum claimed to be attributable to such special features. (*Schieffa v. Clark* (E.C.A.1947) 163 F.2d 685.) The court held that the use of the plaintiff's own figures did not constitute a denial of due process even though the manufacturer had received no prior notice of the purpose for which the administrator might use the figures.

telling the utility of the method by which it arrived at its figures or permitting it to challenge them; the court held this procedure unconstitutional.

Without belaboring the obvious differences between the unconstitutional procedure in *Ohio Bell* and that proposed in the case of annual adjustment, we simply note that in the latter instance the operative assumptions of the commission would at all times be known to the parties. (Accord, *Maare-McCormack Lines, Inc. v. United States* (1969) 413 F.2d 568, 585, 188 Ct.Cl. 644.)

In striking down the procedure in *Ohio Bell* the court made reference to an earlier case upon which the utilities before us rely; *West Ohio Gas Co. v. Comm'n* (No. 2), *supra*, 294 U.S. 79, 55 S.Ct. 316, epitomized the defects also found in *Ohio Bell*. In *West Ohio* the regulatory agency had, in setting a rate in 1933, chosen to rely exclusively on data from 1929, ignoring available revenue and expense data from 1930 and 1931; the court held this procedure unconstitutional.

In examining the flaws in *West Ohio* one is struck by the contrast they present to the proposed annual adjustment clause in question, in spite of the utilities' assertion to the contrary. The defect in the *West Ohio* case lay in the commission's refusal to consider the latest available data as to costs and revenue; yet annual adjustment entails precisely the substitution of actual figures for guesses and estimates of tax expense and deferred reserves. Rather than taking a single year as the measure of tax reserves, the commission staff proposed to make period adjustments in the figures in the light of actual experience, precisely the course approved by the court in *West Ohio*. The Utilities, of course, complain that the commission would make such adjustments only in the tax deferral figures, and not in the other revenues and expenses of the company; but, as we have already shown, the distinctive treatment of tax expenses and reserves finds its warrant in the circumstance that under accelerated depreciation they will vary abnormally with respect to the other components of the utilities' finances. Simply to recognize this fact is not to deny due process. [701]

[10] Nor does due process require a hearing that serves no useful purpose. In the instant case the only relevant inquiry turns upon the figures that stand in specified places in the utilities' books. No facts are open to serious dispute, no witnesses' demeanor need be judged, no policy decisions on which public sentiment might prove useful are before the commission. Within such a context, the facts are those which Professor Davis terms "legislative," and as to which a hearing serves no function.[39] (1 Davis, Administrative Law Treatise (1958) pp. 429–437 (1970 Supp.) pp. 327–329; *Rivero v. Division of Ind. Welf.* (1968) 265 Cal.App.2d 576, 71 Cal. Rptr. 739.)

The crux of the utilities' objections to annual adjustment lies in the possibility that under certain circumstances the annual adjustment clause might yield a rate below their authorized return, or in extreme situations, they assert, on the border of confiscation. The crucial point which they fail to discern, however, is that *any rate may have such an effect, no matter how calculated.*

An entirely fixed and stable rate may, if expenses rise dramatically, yield insufficient revenues to guarantee the utility a reasonable return. Yet we have never

39. Nothing we say, of course, would preclude the commission from permitting the utilities to submit written briefs at the time of the annual adjustment, if the commission thinks such a procedure useful. Under the circumstances, however, this practice is not constitutionally mandated. (Cf. 1 Davis, Administrative Law Treatise (1970 Supp.) p. 332; *Dyke Water Co. v. Public Utilities Com.* (1961) 56 Cal.2d 105, 14 Cal.Rptr. 310, 363 P.2d 326, cert. den. 368 U.S. 939, 82 S.Ct. 380, 7 L.Ed.2d 338.)

viewed this possibility as a ground for constitutionally requiring expense escalation clauses; the appropriate remedy in such instances is an application for a rate increase (Pub.Util.Code, §§ 454, 455). Conversely, the fact that a tariff containing an annual adjustment clause keyed to the growth of a deferred tax reserve may, under imaginatively conceived circumstances, reduce the rate of return below that authorized does not render it unconstitutional.

The utilities' objections are therefore inapposite. The due process cases they cite are, as we have shown, concerned with procedural defects not here present. Nothing in the procedures suggested to the commission will deny the utilities full hearings both on the system of accounts which will yield the figures in question and on the formula to which the figures will be applied.

1(c) *The commission therefore erred in failing to consider annual adjustment.* 1104

[11] Because annual adjustment comports both with the governing statutes and the Constitution, the commission failed regularly to pursue its authority in failing to consider it.[40] (Pub.Util.Code, § 1757.) On remand the commission should proceed either to take further testimony on the system, or to consider its adoption on the basis of the testimony contained in the record of the instant cases.[41] It should in any case weigh its desirability and set forth the reasons for the decision it ultimately reaches.[42] (Pub.Util.Code, § 1705.)

40. In its opinion on denial of rehearing in the Pacific case the commission set forth an alternative proposal which entailed its reception of periodic reports of the utilities' profits with an eye towards reopening proceedings should they exceed the authorized rate. (*In re Pacific Telephone and Telegraph Co.* (1974) Cal.P.U.C. (Decision No. 83540).) The commission subsequently adopted the same procedure for General. (*Re General Telephone Company* (1974) Cal.P.U.C. (Decision No. 83770, slip opn., pp. 29–31.)) While such continuing supervision appears to be in commendable accord with the commission's statutory duties (Pub.Util.Code, §§ 451, 701, 728), it fails to serve as an adequate substitute for the consideration of annual adjustment on two grounds. First, the holding out of the possibility of future action does not constitute a justification for failure to take present action. Second, the commission's procedure verges dangerously on shifting the burden for justification of rate increases from the utility, where Public Utilities Code section 454 places it, to the ratepayer. The commission's order on denial of rehearing therefore does not alter the outcome of the instant case.

41. Pacific, of course, has had a full hearing on the use of annual adjustment, and as to it the commission enjoys the election described. In the General proceedings, the commission, although under a duty to do so, did not consider annual adjustment, and General consequently stands entitled to a hearing before incorporation of the system into its rates.

42. In this connection we emphasize that nothing in the course of this opinion should be construed as binding the Public Utilities Commission either now or in the future to any *particular* method of rate-setting which it decides is not useful. For instance, because the size of the utility's reinvestment is affected by the rate of inflation in the entire economy, under certain severe conditions of deflation even a utility expanding its plant investment would not incur sufficient expense (because the replacements would cost substantially less than the old assets) to offset the lower depreciation attributable to "old" assets in their later years. Under such conditions a public regulatory commission might well adjust its rate-setting assumptions. (Cf. *Power Com'n v. Hope Gas Co.*, *supra*, 320 U.S. 591; *Blaefield Co. v. Public Serv. Com.* (1923) 262 U.S. 679, 692–693, 43 S.Ct. 675, 67 L.Ed. 1176.) Thus, should conditions change, or should the commission in the *considered* exercise of its discretion (Pub. Util.Code, § 1705) conclude that a method which we hold it empowered to employ is not suitable, it may reject the method.

Conversely, should the commission on remand decide that a method which it has previously rejected on prudential grounds now appears feasible, it may adopt the method. Thus, if, upon reconsideration, the commission should conclude to implement pro forma normalization on a tentative basis, with rates held in a trust fund, subject to refund upon final determination of federal tax questions, nothing we say here should be construed to forbid such a course of action. Alternatively, the commission could choose to mitigate the "windfall" accruing to rent parties in interest in consequence of their failure to elect accelerated depreciation prior to 1969, by setting more modest rates of return in recognition of

[1b5] 3. *The commission did not otherwise err.* In the decisions before us the commission ruled as to a number of points other than those already discussed; the petitioning cities complain of several of these rulings. We have carefully examined both the petitioners' contentions and the record before the commission and find no error calling for annulment other than that indicated above.[43] (Pub.Util.Code, § 1757.) We dwell further on only one point which, because it relates to commission procedure, may recur.

The petitioning Cities of Los Angeles and Long Beach (in S.F. 23237) complain that the commission erred in failing to abrogate General's entire tariff after we annulled Pacific's tariff in *City and County of San Francisco v. Public Utilities Commission, supra,* 6 Cal.3d 119, 98 Cal.Rptr. 286, 490 P.2d 798. In order to show that the commission did not err, we briefly set forth the relevant chronology.

When we disapproved the commission's order in *City and County of San Francisco*, the commission had just filed a decision incorporating a rate increase for General Telephone, based in part on the same treatment of federal tax expenses which we held erroneous in the *Pacific* case. (Re *General Telephone Co. of Cal.*, 72 Cal.P.U.C. 652.) Upon learning of our decision in *City and County of San Francisco* the cities which had appeared before the commission in the proceeding leading to the General decision, petitioned for a *rehearing* which the commission granted. (Decisions Nos. 79532 and 79367.) We subsequently annulled the entire rate based on the tax decision held erroneous in *City and County of San Francisco.* (*City of Los Angeles v. Public Utilities Commission, supra,* 7 Cal.3d 331, 102 Cal.Rptr. 313, 497 P.2d 785.)

In granting rehearing the commission limited the issues to the question of tax expenses and promulgated the previous tariff as an *interim* rate subject to refund if the commission subsequently found it erroneous. After this rehearing (at which the commission did not consider annual adjustment), it effectively reaffirmed the interim rates as part of the permanent tariff. [1b6]

From the previous discussion, it is clear that as a substantive matter the commission erred in failing to consider annual adjustment.[44] The petitioning cities also complain, however, that the commission erred in repromulgating the tariff under attack as an *interim* rate; by analogy to our action in *City of Los Angeles* they argue that the commission bore the duty to annul the *entire* rate. Because the rates suffered from the same failure to consider alternatives, they argue, both rates must have been annulled. In this analogy between our decision and the commission action, however, lurks a fatal flaw.

The key to the distinction between the two cases lies in the difference in the commission's power, on one hand, to *reopen* proceedings already final, and, on the other, to *rehear* a decision not yet final. In *City of Los Angeles* we annulled the tariff in

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44. Because the commission took the steps just outlined, we were not called upon to annul General's rate as we had that of Pacific in *City and County of San Francisco.* The governing law, however, was clear from that case, and the commission bore a corresponding similar duty to consider alternative methods of dealing with General's accumulating tax reserves. Annual adjustment was before it in the parallel proceedings after annulment in the Pacific case, which was filed before the decision on rehearing in the General case.

question, in spite of the fact that the commission had *reopened* rate proceedings under Public Utilities Code section 1708. That section, which we set forth in the margin,[45] permits the commission at any time to reopen proceedings even after a decision has become *final*, as the commission decision in City of Los Angeles would have been had we not annulled. (*City of Los Angeles v. Public Utilities Commission, supra*, 7 Cal.3d 331, 102 Cal.Rptr. 313, 497 P.2d 785.)

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1107 [12, 13] In the General case, on the other hand, the time for *rehearing* had not expired and the rate had not become final and lawful. The difference in effect stems from the difference between Public Utilities Code section 1736,[46] which provides for an order on *rehearing*, and section 1708 which provides for *reopening*. The former procedure, which must take place within the time limits specified in section 1731, and only in response to parties' requests, contrasts with the latter, which is merely a general authority for the commission to reconsider something upon which it has previously ruled. Rehearing, unlike reopening, prevents an order previously made from becoming final. (See *Safe v. Railroad Commission* (1940) 15 Cal.2d 612, 616, 104 P.2d 38.) Because the commission *reheard* the General case, its order did not become final, and it could promulgate an interim rate subject to refund. The commission's procedure in Decision 83778 was therefore lawful although its substantive result must be annulled for failure to consider annual adjustment.

4. *Order.*

Because the commission has failed regularly to pursue its authority, the rates here under review may not stand in their entirety. (Pub.Util.Code, § 1757.) Yet, because we have found error only in respect to the treatment of tax expenses, we need annul only the portion of the rate based on such error. Unlike the situation facing us in *City of Los Angeles v. Public Utilities Commission, supra*, 7 Cal.3d 331, 102 Cal. Rptr. 313, 497 P.2d 785, in which we noted that "[n]o basis appears to sever these matters from the increase of rates ordered by the commission, and it is not claimed that severance is possible" (*id.*, at p. 354, 102 Cal.Rptr. at p. 330, 497 P.2d at p. 802), the commission in the instant case has

45. "The commission may at any time, upon notice to the . . . parties, and with opportunity to be heard as provided in the case of complaints, rescind, alter, or amend any order or decision made by it. Any order rescinding, altering, or amending a prior order or decision shall, when served upon the . . . parties, have the same effect as an original order or decision." (Pub.Util.Code, § 1708.)

46. Section 1736 reads in its entirety as follows: "If, after such rehearing and a consideration of all the facts, including those arising since the making of the order or decision, the commission is of the opinion that the original order or decision or any part thereof is in any respect unjust or unwarranted, or should be changed, the commission may abrogate, change, or modify it. The order or decision abrogating, changing, or modifying the original order or decision shall have the same force and effect as an original order or decision, but shall not affect any right or the enforcement of any right arising from or by virtue of the original order or decision unless so ordered by the commission."

gone to some lengths to "set out the dollar effect of the adjustment so that if . . . [it is] found wrong . . . the correct adjustment can readily be made." (*Re Pacific Telephone and Telegraph* (1974) Cal. P.U.C. (Decision No. 83162, slip opn. p. 64).)

Not only such passages but also the commission's actions in these cases demonstrate the severability of the tax related aspects of the rates before us. Thus upon rehearing in the General case, the commission discovered that California taxes, unlike their federal counterparts, were amenable to flow-through treatment and ordered appropriate refunds, thereby demonstrating the practicability of partial annulment. (Re *General Telephone of California* (1974) Cal.P.U.C. (Decision No. 83778, slip opn. pp. 48–49).)

In order, therefore, not to interfere with those portions of the tariff in which we find no reversible error, we affirm the commission's order except insofar as it depends upon the erroneous treatment of tax expenses set forth above; as to that portion of the rate we annul. The commission, on remand of this matter for further proceedings consistent with this opinion, shall expeditiously determine what position it will adopt with respect to the tax expense issue. (See *City & County of San Francisco v. Public Utilities Com., supra,* 6 Cal.3d 119, 130–131, 98 Cal.Rptr. 286, 490 P.2d 798.) Having ascertained this position, be it annual adjustment or some other alternative, including the possibility of a commensurate adjustment in the rate of return, the commission shall provide for refunds, if appropriate, to the ratepayers of the differenee between such a rate and the tariff reviewed herein.

WRIGHT, C. J., McCOMB, MOSK, CLARK, and RICHARDSON, JJ., and TAYLOR,* J., Assigned, concur.

542 P.2d 1390
15 Cal.3d 729

The PEOPLE, Petitioner,

v.

The SUPERIOR COURT of MONO COUNTY, Respondent;

Donald J. ZOLNAY et al., Real Parties in Interest.

S. F. 23310.

Supreme Court of California, In Bank.

Dec. 16, 1975.

Rehearing Denied Jan. 14, 1976.

The People petitioned for a writ of mandate seeking review of trial court's order granting defendants' motion to suppress their confessions as well as physical evidence seized following the confessions. The Supreme Court, Richardson, J., held that evidence seized as result of an unlawfully obtained admission or confession may be suppressed pursuant to a section 1538.5 motion seeking return of property or suppression of evidence, that one defendant's question or statement as to need for a lawyer constituted a sufficient invocation of right to remain silent and that although deputies then left defendants alone for five to ten minutes, with message that defendants could make the officers' jobs "easy or tough," defendant's subsequent statements to deputies were not independent and volunteered.

Alternative writ of mandate discharged; petition for peremptory writ denied.

Opinion, Cal.App., 121 Cal.Rptr. 162, vacated.

1. Criminal Law ⇐394.6(1)

Evidence seized as result of an unlawfully obtained admission or confession may be suppressed pursuant to a motion to return property or suppress evidence. West's Ann.Pen.Code, § 1538.5.

* Assigned by the Chairman of the Judicial Council.

[1703] [1] 3. *The commission did not otherwise err.*

In the decisions before us the commission ruled as to a number of points other than those already discussed; the petitioning cities complain of several of these rulings. We have carefully examined both the petitioners' contentions and the record before the commission and find no error calling for annulment other than that indicated above.[43] (Pub.Util.Code, § 1757.) We dwell further on only one point which, because it relates to commission procedure, may recur.

The petitioning Cities of Los Angeles and Long Beach (in S.F. 23237) complain that the commission erred in failing to abrogate General's entire tariff after we annulled Pacific's tariff in *City and County of San Francisco v. Public Utilities Commission, supra,* 6 Cal.3d 119, 98 Cal.Rptr. 286, 490 P.2d 798. In order to show that the commission did not err, we briefly set forth the relevant chronology.

When we disapproved the commission's order in *City and County of San Francisco,* the commission had just filed a decision incorporating a rate increase for General Telephone, based in part on the same treatment of federal tax expenses which we held erroneous in the *Pacific* case. (Re *General Telephone Co. of Cal.,* 72 Cal.P.U.C. 652.) Upon learning of our decision in *City and County of San Francisco* the cities which had appeared before the commission in the proceeding leading to the General decision, petitioned for a *rehearing* which the commission granted. (Decisions Nos. 79532 and 79367.) We subsequently annulled the entire rate based on the tax decision held erroneous in *City and County of San Francisco.* (*City of Los Angeles v. Public Utilities Commission, supra,* 7 Cal.3d 331, 102 Cal.Rptr. 313, 497 P.2d 785.)

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Mr. DANIELSON. You may proceed.

Mr. CHANDLER. Thank you, Mr. Chairman. First I would like to summarize the reasons that the California Public Utilities Commission joins with you in the desire to create an early and binding mechanism for determination of utility tax benefit eligibility.

Second, I would like to review the history of the California situation. I think I can provide some information that the other witnesses omitted and give the subcommittee some additional perspective on the matter.

Finally, I would like to address the A.T. & T. proposal for an addition to H.R. 229, a provision for an injunction, which the commission vigorously opposes.

We feel the adoption of a declaratory judgment mechanism would reduce uncertainty which works to the detriment of regulators and companies alike. There can be absolutely no doubt that uncertainty over tax benefit eligibility can cause serious problems in the regulatory process. I think the other witnesses have addressed very well some of the sorts of problems that can arise with respect to that uncertainty. We do have particular reservations to some of the provisions in H.R. 229, however.

First, we would like to see a more clear statement in the legislation that it is limited to the tax implications of eligibility. Currently, there is language which refers to ratemaking provisions.

Second, a clear statement that if the declaratory judgment would give rise to any additional relief, to a basis for any additional relief, that that additional relief be sought in the manner currently prescribed; that is, through the State courts, consistent with the longstanding Federal policy under the Johnson Act.

Third, we feel any party to the ratemaking proceeding which gives rise to the declaratory judgment suit should be a necessary party to the declaratory judgment suit, and furthermore, that any party to the ratemaking proceeding should be able to bring a declaratory judgment suit. Since all parties to the ratemaking proceeding may be able to appeal to the State courts the ultimate ratemaking finding of a State commission, we feel it important that all parties be able to utilize any judicial mechanism that would be available. Since this would be an additional judicial mechanism, we would like to see all the parties to the ratemaking process have access to it.

Finally, we would like a provision mandating the exercise of administrative rights by utilities in order to effectuate pleadings for declaratory judgment by nonutilities. Your bill currently permits the regulator to seek a declaratory judgment. However, the ability to do that is dependent upon the utility exhausting its administrative remedies. We want to insure that other parties who might want to seek declaratory judgments will not be barred from doing so by the failure of the utility to exhaust its administrative remedies.

With those changes we are eager to support the legislation.

With respect to the situation which has arisen in California, I hope I can make the California commission somewhat less peculiar than some of the other witnesses have made it out to be by giving you some of the history.

In 1968, and this part of the history is relevant, the commission adopted, with respect to Pacific Telephone, the same policy it had

with respect to the other utilities, which was endorsed by the State supreme court, and that is flow-through treatment. At that point there were no conditions on eligibility for tax benefits. Utilities were eligible for tax benefits regardless of the ratemaking and accounting treatment that was used for the benefits. Unlike other California utilities, Pacific and General, chose not to elect accelerated depreciation rather than elect the benefits and flow them through. That is contrary to what the ratemaking body had asked them to do. So the public utilities commission announced it would set rates on a flowthrough basis and the utility chose not to elect the tax benefits, that was their own problem. That action of the commission was upheld in the State supreme court.

Mr. DANIELSON. Was that the matter which was a decision based upon denial or review, or was that actually a decision?

Mr. CHANDLER. No; that was actually a decision. In 1969 the Federal law was passed conditioning eligibility on the adoption of the normalization method. At that point, Pacific and General indicated they wanted to elect accelerated depreciation. The commission said "all we can do is provide normalization because that is what the Federal law says." The case was appealed by some intervenors to the State supreme court, which ruled 7 to 0 that it was improper for the commission to give the utilities full normalization without seeking alternatives, since it was rewarding them for their "imprudence" in refusing to elect the benefits earlier. The matter was remanded by that 7-to-0 vote with instructions to set rates in a way that would be lower for consumers than under full normalization, and the supreme court specifically stated that the effect on eligibility should not bind the commission. In other words, if the commission wanted to adopt a method which denied the utilities eligibility, that would not be inconsistent with California law.

Those words of the California supreme court are included in the decisions which I have submitted to be included in the record.

The commission responded to that by saying "no, we have to let them normalize." The case was again appealed to the State supreme court and a year later, in 1972, the supreme court said, 7 to 0 again, "no, we told you not to normalize," and remanded the case for a third time.

On the third occasion, the commission said "we have to normalize. There is nothing else that we can do." In December 1975, again by a 7-to-0 vote, the California supreme court, pointing back to its earlier decision, when it referred to the utilities imprudence, said "we do not want you to do that." At that point, the court specifically directed the commission to adopt the average annual adjustment method of normalization, which was adopted in 1977.

The 7-to-0 decisions by the California supreme court were made during the last years of the tenure of Governor Reagan, not a period when the court was particularly noted for judicial activism, yet the decisions were 7 to 0 against the companies and the commission on the normalization method.

I would like to emphasize that the court did not state that eligibility was a central matter. It was a concern, but not the central concern. When the commission adopted the average annual adjustment method in 1977, it sought to structure that method in such a way that it would be consistent with the normalization statute, so that the company could

elect the tax benefits and get the benefit of that, while accounting for them in a manner so that the utility customers would benefit as well. The basis of the commission's position is its method, is consistent with the statute, and I refer the committee to a January 1979 article in the Stanford Law Review which takes that position. That's a matter that has to be litigated. Were a declatory judgment mechanism available to test that earlier, then the commission would have known what the eligibility was. But under the terms of the remand order, it is unclear there was anything that could have been done by the commission. The reason the commission has opposed additional review in Federal court is that the commission feels the remand order of the State supreme court is the alpha and omega of the commission's authority, and regardless of any other determination, the commission is limited by what the supreme court has told it to do. There are California precedents for the commission position in that respect.

I think that probably provides a little more perspective on the position the commission has been in throughout the last 11 years in this case, and points to the fact that the declaratory judgment mechanism might have been interesting, but it is unclear that it could or would have made all that much difference. I think what the companies would like to do, and it is particularly from the A.T. & T. injunction provision that I draw this understanding, is to provide a way for them to overcome the three decisions of the State supreme court which directed the commission to adopt the method currently being put into effect and to thereby negate a $300 million refund order of the commission. That is about $30 to $40 per household in California, by the way.

The way they would seek to do that is basically a back door to what the company tried to do directly in 1969 but was rebuffed by the Congress. The original normalization legislation, H.R. 6659, which A.T. & T. testified to in the Ways and Means Committee, provided that normalization must be adopted by State commissioners. Chairman Mills rejected that, fearing that it would violate the 10th amendment provisions regarding State powers, and instead adopted the eligibility conditions.

The only sort of real relief that could be obtained by a utility would to obtain an injunction which would stop the State commission's order and require the provision of tax benefits to the company as if the benefits were the property of the company. That sort of provision we oppose, the reason being we think Congress was clear in making eligibility requirements and that a back-door mechanism such as an injunction should not be used to mandate normalization, when a loss of eligibility is, as Mr. Dalenberg pointed out, perfectly proper under the law. That sort of injunction mechanism would be a great interference in the traditional prerogatives of the States to set rates. I think that goes back to the separation of powers between Federal and State governments it goes back to the founding of the country, and certainly it goes back 45 years to the congressional enactment of the Johnson Act, which states that the district courts shall not suspend, enjoin, or restrain State ratemaking except for several limited exceptions which have been construed narrowly. That sort of injunction provision is therefore reprehensible to State ratemaking since it would have a direct effect on rates. We share the desire for an early determination of eligibility. We object to the creation of a judicial mechanism violating the 10th

amendment and taking away the traditional prerogatives of States as to State ratemaking.

Mr. DANIELSON. Thank you.

Mr. McClory of Illinois?

Mr. MCCLORY. Thank you very much. I am a little puzzled about your goal here. You do not state what your position is. Are you an officer, or counsel, for the California commission?

Mr. CHANDLER. I am not on their payroll currently. I worked for the president of the commission for 2 years and I was asked by the commission to testify, and I testified at their request alone.

Mr. MCCLORY. You must have represented some other interest in at least part of this.

Mr. CHANDLER. The commission is the only interest in respect to this case that I have ever represented.

Mr. MCCLORY. You have not represented any of the consumer groups or other interests?

Mr. CHANDLER. Never anybody who is a party to this case.

Mr. MCCLORY. Are you a former employee of the commission?

Mr. CHANDLER. I am on leave right now, but will be returnig to them shortly.

Mr. MCCLORY. You are not employed by anybody else now who is interested in this proceeding?

Mr. CHANDLER. No.

Mr. MCCLORY. Are you a volunteer here today?

Mr. CHANDLER. I am; a little pro bono work.

Mr. MCCLORY. At your own expense?

Mr. CHANDLER. At my own expense completely.

Mr. MCCLORY. I think really the key element in your testimony, as far as your support of declaratory judgment proceeding, is that which would permit intervention by what you call consumer groups, the League of Cities and other private groups. Without that kind of intervention, you would not want to support this legislation.

Mr. CHANDLER. It is not a question of additional intervention, it is a question of taking parties who are already in the process of determining rates in a given case and making sure they are parties to the entire process.

Mr. MCCLORY. The utilities interest is the tax determination. They want a determination as to depreciation, as to investment tax credits, and that sort of thing. Now, I have never heard of a proceeding between the IRS and the taxpayer in which you have intervention by consumer groups and States attorneys or attorneys general.

Mr. CHANDLER. You are providing for the participation by the ratemaking body. The principle is the same. The basis for the participation of such groups in the ratemaking process is that they represent the rate payer and that in any matter affecting rates, the ratepayer's voice deserves representation. As Mr. Dalenberg and Mr. Hart have so well pointed out, tax status effect rates. It is important that those ratepayer interests be represented in a declaratory judgment suit as well as in the remainder of the regulatory process.

Mr. MCCLORY. So, while they envision this as a proceeding involving a tax liability or tax benefit, you regard this as an extension of the ratemaking procedures that have been pending?

Mr. CHANDLER. It is a matter which affects rates, and that is the basis for that provision.

Mr. McCLORY. You mentioned a $300 million refund. That is the first time I have heard about that in this proceeding. Have you any interest in that? Do you represent any consumers?

Mr. CHANDLER. I am a Pacific Telephone subscriber. That's my only interest as a consumer.

Mr. McCLORY. You are not a part of a class action?

Mr. CHANDLER. No.

Mr. McCLORY. Are there private counsel employed in a class action?

Mr. CHANDLER. Not that I am aware of. There may be such a suit, but I am not aware of it.

Mr. McCLORY. Is there anything further you would like to explain to me as far as your interest in this proceeding, because I continue to be somewhat puzzled by a volunteer coming here to represent a State regulatory agency at his own expense. It is a unique experience to me.

Mr. CHANDLER. Perhaps a little more detail with respect to my employment by the commission will be helpful. From July 1977 until June 1979, I worked for the president of the commission, for President Robert Batinovich, until January 1979; and when he was replaced at that time by President John Bryson, for Mr. Bryson I worked particularly on this issue for those individuals and when this hearing was scheduled, the individual who would have been most likely to come testify was Commissioner Gravelle. He was unavailable. I was discussing the hearing with him and advised him I knew it was going to be happening, and he and Commissioner Bryson suggested that I represent the commission here today.

Mr. McCLORY. You feel you are representing the consumers of California?

Mr. CHANDLER. I represent the commission. The position I stated was the position that the commission has taken throughout on this matter. A letter was sent to the Treasury Department which I will be happy to include—it was also sent to the subcommittee, I believe—on this matter some months ago, which takes the same position which I am taking today.

Mr. McCLORY. If we did not provide in the legislation for intervention, which I think would be a new wrinkle in the law, would you still favor this legislation?

Mr. CHANDLER. I would be happy to consult with the commissioners and provide a letter. I cannot speak for the commission on a question such as that. I think it is a matter viewed importantly by the commission.

I would like to emphasize that we do not view it as additional intervention. The reason we think it important to include the other parties is that these cases before the California Supreme Court were in a couple of cases brought against the commission when the commission provided for normalization by such groups. It would be valuable in dealing with their appeals of the commission's findings if they were party to the declaratory judgment suit. I think it would obviate the need for additional appeals.

Mr. McCLORY. You do not have any fear that the dilemma in which the utility company finds itself in would jeopardize the furnishing of service to California customers?

Mr. CHANDLER. As Mr. Dalenberg pointed out to Representative Barnes, the company has accounted for the possibility of paying those taxes in its books already.

The bulk of the funds were funds collected, as Mr. Dalenberg pointed out, under a normalization order and put into a deferred tax reserve for repayment to the Treasury.

Mr. MCCLORY. I understand that. That is the reason for this legislation, the investment tax credit and the depreciation allowances are provided for under the tax laws but not at the time at which a ratemaking process is developed and applied.

I do not have any further questions.

Mr. DANIELSON. I wish to expand on your status here. In your statement, you say you are speaking for the California Public Utilities Commission and also you speak on behalf of the people of California. Taken at face value, that is a broad statement, and I am dismayed that the nature of your relationship was not made eminently clear to this committee before.

A while ago you said you did work for the president of the commission. When was that period of time?

Mr. CHANDLER. I began on July 5, 1977, and I concluded on June 1, 1979, and will be beginning on September 1, 1979.

Mr. DANIELSON. Do they know you are here today?

Mr. CHANDLER. Yes; they do. As regards the statement regarding the people of California, that is in there at the request of Commissioner Gravelle, who asked me to make sure it is known that when the commission speaks, it speaks for the State and the people of California. That came directly from the commissioner.

Mr. DANIELSON. We have a two- or three-layer orally constituted agency here.

One more thing, you say you worked for the president of the commission. On his personal staff? Did you work for the president of the commission or the commission?

Mr. CHANDLER. They are one and the same. I was on his personal staff but paid by the commission. I was attached to the policy and program development unit.

Mr. DANIELSON. You were then an employee of the California Public Utilities Commission?

Mr. CHANDLER. Yes, and I will be. The reason I am not employed there now is, there was a typical foulup which the State of California has many times with personnel——

Mr. DANIELSON. Not many times, that is why I am asking you the question. You have the burden of proof.

Mr. CHANDLER. If my own case is any example, I will have plenty. It was a necessity because of the personal rules that I take a 3-month leave of absence. As a result I am on leave and will be rehired.

Mr. DANIELSON. Thank you.

Mr. Barnes of Maryland?

Mr. BARNES. When I was a member of the Maryland Public Service Commission I had occasion to work with the California Public Utilities Commission and the president was Mr. Batinovich and I know Mr. Chandler was employed with the president working on this issue and other issues, because I had occasion to meet Mr. Chandler when he was from time to time in Washington, and he was sometimes here with

President Batinovich so I know he is what he purports to be this morning at this hearing. And I also know the reason he is on leave of absence from California is that he has had an opportunity to take an interesting high-level internship in the executive branch of the Federal Government. And I suppose they decided to ask Mr. Chandler, who is already in Washington, to appear here this morning. At least that is my understanding.

Mr. DANIELSON. I thank the gentleman for setting the record straight.

Mr. BARNES. What is the assessment of the commission with respect to the implications as to loss of revenue? What are the other companies doing? Could you give us the commission's perspective on the financial implementations?

Mr. CHANDLER. Pacific and General are the only companies covered by this particular order with respect to normalization. I might point out that since the present commission started taking office at the beginning of 1975, the price of Pacific Telephone stock has risen by 16 percent; in the last year alone the price of A.T. & T. stock has dropped by 15 percent.

The commission is committed to maintaining the financial health and viability of all the utilities in California.

I have a variety of investment research summaries of utilities which talk about the financial health of California utilities and urges people to buy their stock.

In relation to the particular situation Pacific Telephone finds itself in now, we feel substantial reserves have been accumulated through the collection of revenues under normalization and that those reserves were intended to be paid to the Government that the IRS generally allows for repayment over an extended period of time; and furthermore, if there is any shortfall which threatens the financial health of the company or threatens telephone service of Californians, that that obviously will be made up for. The commission is committed most of all to adhering to the law and as has been pointed out by Mr. Dalenberg, it is certainly not a violation of the law to be ineligible for tax benefits; again, however, we don't feel these companies will be ineligible.

The Supreme Court of California has told us three times it would be a violation of the law to provide the company with full normalization. We are doing our best to walk a very narrow line, and I can assure the subcommittee that the commission will not allow the telephone service of Californians to deteriorate because of this situation. We feel equally strongly with the other witnesses that it is an unfortunate position to be in. That is why we are here to support the concept of the declaratory judgment mechanism and feel that had it been available in the past, the State supreme court might have given additional consideration to the method we have chosen but it is our position and we believe that method will be upheld, but it would have been nice to have known earlier.

Mr. BARNES. Assume the legislation passes, with or without the injunction provision, and the company is found ineligible in a suit for declaratory judgment, what would the response of the California Commission be?

Mr. CHANDLER. Well, once again, the State supreme court's order did not focus on the eligibility issue. They said it was something to be

taken into account by the commission, but it was not the central thing to worry about. The position of the commission has been in the past that we are bound by the terms of our remand order, 7 to 0, by our State supreme court.

I share with Mr. Dalenberg the sentiment that the legislation may not be applicable to the current situation. But that has been the position of the commission in the past. If there is any change in that position, I will inform the subcommittee.

Mr. BARNES. What could have been done to avoid this in the judgment of the commission? How could this whole thing have been avoided, because it is clearly a serious problem for the company, for the ratepayer.

Mr. CHANDLER. It is a difficult question. A lot of it has to go back to that point in 1968 when the company refused to elect tax benefits, a move the State supreme court described as "imprudent," and characterized their conduct as "obstinate." From then on, the matter unfolded as in a Greek tragedy. We are working, we are hopeful, and all over, efforts and energies are focused on retaining eligibility.

But the whole impasse has developed because of the company's reaction at that time which led to the remand orders. I think one reason we have a problem with respect to the Bell company in this matter and not with respect to, for instance, our energy utilities, is because those energy utilities are California companies, whereas A.T. & T. obviously has a national interest in these tax benefits and is willing to sacrifice the interest of the California operating company and the California ratepayers for the sake of their national position, and that was the basis of their 1968 decision not to accept tax benefits, and that is what brought them into conflict with the law of California.

Mr. DANIELSON. Mr. Kindness of Ohio.

Mr. KINDNESS. I would like you to be more specific, not having done my homework on part of this, on suggestions made in behalf of the commission. Objection No. 1, that section 2202(a) of the bill is not clearly limited to the eligibility, and in particular, objection is made as to the ratemaking legislation.

It has been my impression 2202(a) is the eligibility section.

Mr. CHANDLER. We are not sure what the impact of the present language would be. What we would like to see is a clear statement that the declaratory judgment would be made only with respect to the eligibility. I think that was the intent of the chairman in the drafting of the bill and I think what we are proposing is consistent with what is probably in the bill currently; we just prefer to have it spelled out.

Mr. KINDNESS. I have what is being considered as a proposed amendment which would cause that language to read—"or any ratemaking method or order affecting a public utility's eligibility for tax benefits conferred by such sections".

Would that seem to come closer to what the commission would prefer?

Mr. CHANDLER. I would like to look at it written down.

Mr. KINDNESS. But while you are here, I would like to pin this down.

Mr. CHANDLER. No; I do not think that goes directly to it. What would go directly to it would be to say—"declaratory judgment with respect to the effect of any ratemaking method or order on a public utilities eligibility for tax benefits conferred by such sections."

I will be happy to provide that to you later, those suggestions, write them down in a form the committee can work with. This amendment you have provided me with seems to broaden the proivision to include any ratemaking order affecting eligibility rather than to merely cover the eligibility issue, as it arises under an order.

Mr. KINDNESS. I understand the point you are making. It seems to me to be a valid one, but I have not, as I say, done my homework on this. I thought the language in the bill—at first I thought it had provided a narrower area of focus. But I see your point and we would appreciate any further language refining that you might have to offer.

Mr. CHANDLER. I will be happy to provide that.

Mr. KINDNESS. I want to yield to the gentleman from Illinois.

Mr. MCCLORY. I want to clear up one thing. My colleague, Mr. Barnes, suggested you were here in Washington in some executive branch capacity. Would you identify for us what your official position is?

Mr. CHANDLER. I would be happy to. As I said, I would not be here if it were not for the personnel foulup with respect to the 3-month period. Presently, I am working for the Council on Wage and Price Stability in an area unrelated to this issue.

Mr. MCCLORY. You are on leave of absence from there in order to testify in behalf of the California Commission today?

Mr. CHANDLER. I am.

Mr. DANIELSON. I have one point to cover only. There is in being a controversy between the California Public Utilities Commission, Pacific Telephone, and possibly some other utilities. It is a controversy we have been discussing here this morning. If this bill were to pass in any form, but preserving the declaratory judgment feature, it would have a retroactive effect, I would imagine, or could have, for the purpose of resolving that dispute.

Am I correct so far?

Mr. CHANDLER. The commission's position has been that we are bound by the remand order of the State supreme court.

Mr. DANIELSON. My question was, if this bill were to pass and were to provide for declaratory relief, would it not have retroactive effect insofar as the existing dispute between California Public Utilities Commission and Pacific Telephone is concerned?

Mr. CHANDLER. I am afraid I do not understand——

Mr. DANIELSON. I am referring to the difference of opinion of the California Public Utilities Commission, their interpretation as to how these tax laws should apply. There is an existing controversy. Would it not apply to the existing controversy?

Mr. CHANLDER. The Commission has not taken a position on that issue.

Mr. DANIELSON. Have you an opinion?

Mr. CHANLDER. My personal opinion?

Mr. DANIELSON. Yes, the only one you have.

Mr. CHANDLER. I am not at all sure what the impact would be.

Mr. DANIELSON. Then taking the same question from a different point of view, do you anticipate if this bill became law and the remedy became applicable, that it would have any remedy in the future? Starting in 1983, obviously you cannot see that far ahead. But do you suppose there would be any occasion to utilize this declaratory judgment in the future?

Mr. CHANDLER. With respect to Pacific Telephone?

Mr. DANIELSON. With respect to Pacific Telephone, General Telephone, or any of the other utilities operating in California.

Mr. CHANDLER. We feel it would be a valuable mechanism and it would be useful in California for determining the effect on eligibility of various ratemaking methods.

Mr. DANIELSON. You feel it would have some value in controversies which have not arisen but which can be reasonably expected to arise in the future?

Mr. CHANLDER. With the exception of the matter involving the telephone companies which was subject to a remand order from the State supreme court, on which I have no position, I think it would.

Mr. DANIELSON. Thank you. I have no other questions.

Thank you very much. And thank you sir for your testimony.

Our next witness is the National Association of Regulatory Utility Commissioners representative, Mr. Paul Rodgers, administrative director and general counsel of the NARUC. Without objection your prepared statement will be made part of the record.

TESTIMONY OF PAUL RODGERS, GENERAL COUNSEL, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, ACCOMPANIED BY MARGO JAMES, DIRECTOR OF CONGRESSIONAL RELATIONS

STATEMENT OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS ON H.R. 229

SUMMARY STATEMENT

The National Assocation of Regulatory Utility Commissioners (NARUC) witness will be Paul Rodgers, Administrative Director and General Counsel of the NARUC.

In Mr. Rodgers' Statement, he will not support nor oppose H.R. 229 at the present time because the NARUC membership has not yet had an opportunity to develop a position on it.

However, Mr. Rodgers will oppose an A.T. & T. amendment to H.R. 229 providing for Federal judicial stays of State ratemaking orders in certain tax controversies.

In the statement, Mr. Rodgers will discuss the Johnson Act, its history, purpose, and the changes that the A.T. & T. amendment would make. In addition, the NARUC officer will demonstrate the detriments the A.T. & T. amendment would have on State ratemaking, concluding that passage of the amendment would push State regulation to a pre-1934 position of the Federal judiciary acting as rate-setters.

Dear Mr. Chairman and members of the subcommittee: My name is Paul Rodgers, and I am Administrative Director and General Counsel of the National Association of Regulatory Utility Commissioners, commonly know as the "NARUC." Accompanying me today is Margo James, NARUC Director of Congressional Relations.

The NARUC is a quasi-governmental nonprofit organization founded in 1889. Within its membership are the governmental agencies of the 50 States, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands, engaged in the regulation of carriers and utilities. The mission of the NARUC is to serve the consumer interest by seeking to improve the quality and effectiveness of public regulation in America.

The members of the NARUC appreciate this opportunity to make their views known on H.R. 229, a bill to amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

At the outset, the NARUC must stress that we do not support nor oppose H.R. 229 at the present time because our membership has not yet had an opportunity

to develop a position on it. This issue will be considered on August 15 and 16, when the NARUC executive committee convenes for its summer meeting.

However, the Association does oppose the proposed A.T. & T. amendment number four to the Johnson Act, 28 U.S.C., Sec. 1342, which states:

4. Amend section 1342 by substituting "(a) Except as provided in subsection (b), the" for the first word "The," and adding new subsection (b) as follows:

"(b) In connection with any action brought under Section 2203, a district court may enjoin, suspend or restrain the operation of any ratemaking order creating the controversy only until such time as the ratemaking body which is a party to the action shall have issued a subsequent ratemaking order."

The Johnson Act has a history that dates to the early days of public utility regulation in America.

Prior to the Johnson Act of 1934, the utilities under the Judicial Code [1] had the right to appeal State commission rate decisions directly to the Federal courts on the alleged grounds of confiscation. This right of appeal allowed Federal District Courts to retry the utility rate cases, develop a new record, and ignore the State commission findings of fact and conclusions of law. In effect, it transferred the power of ratemaking to the Federal judiciary.

Besides the obvious jurisdictional problems caused by such a procedure, direct appeal to a Federal District Court by a utility led to many practical deficiencies in commission regulation. Such procedure impeded, delayed, and, in many instances, prevented State regulatory bodies from reforming their structure. Delays of as much as 11 to 15 years were quite common.[2]

In an effort to protect State jurisdiction and to improve the regulatory process, the NARUC supported legislation in the form of the Johnson Act as an amendment to the Judiciary Act. Approved by President Roosevelt on May 14, 1934,[3] the Johnson Act amended Section 24 of the Judicial Code [4] with respect to the jurisdiction of the U.S. District Courts over suits relating to orders of State administrative boards. The amendment abrogated the jurisdiction of lower Federal courts where an order of a State commission affected rates charged by a public utility; did not interfere with interstate commerce; was made after reasonable notice and hearing; and was appealable in the State courts.

The Johnson Act greatly stabilized the State ratemaking process.

The A.T. & T. amendment in question would severely curtail the operation of the Johnson Act by allowing, in certain cases pertaining to Federal taxes, the Federal courts to interfere with the State regulatory process.

In addition, the A.T. & T. amendment is unnecessary because the rendering of a declaratory judgment by the Federal district court would determine the legal rights of the parties. Hence, there is no need to permit further Federal judicial intrusion into the State ratemaking process.

Thank you for your attention.

Mr. RODGERS. The National Association of Regulatory Utility Commissioners is especially proud of Congressman Barnes. We are pleased he has gone on to greater things and is doing such fine things here in Congress. He was a member of the Maryland Public Service Commission.

The NARUC has not had a chance to take a position on H.R. 229. However, our executive committee is meeting in San Francisco August 15–16 and we will formulate a position on the bill at that time. We are, however, concerned about one of the A.T. & T. amendments which does conflict with the position of the NARUC, that is, the amendment which would permit the district court to restrain the operation of a ratemaking order prior to the issuance of a declaratory judgment. We believe this would open up a Pandora's Box. We feel that this problem was solved in 1934 with the passage of the Johnson Act.

The Johnson Act was introduced and passed at the request of the NARUC, at that time. It is named after Senator Hiram Johnson. Prior

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[1] Judiciary Act of 1789, Sept. 24, 1789, ch. 21, 1 Stat. 73.

[2] See, *New York Telephone Co. v. Maltbie, et al.*, 291 U.S. 645, 78 L.Ed. 1041, 54 S.Ct. 443 (1934); *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133, 75 L.Ed. 255, 51 S.Ct. 65 (1930).

[3] Johnson Act, May 14, 1934, ch. 283, 48 Stat. 775.

[4] Mar. 3, 1911, c. 231 § 24, par. 1, 36 Stat. 1091; 28 U.S.C. § 1342.

to the act the right of appeal allowed the Federal district courts to retry rate cases, and ignore findings of fact and conclusions of law.

We understand that A.T. & T. has proposed a more watered-down amendment and we are very pleased to see this morning that Mr. Dalenberg of Pacific Telephone has indicated that the amendment is not crucial. We think that when the Federal district court issues a decision it will be obeyed. Therefore we believe this kind of amendment is excess baggage. We are certainly glad to see that Pacific Telephone has backed off this type of amendment. We hope this will also satisfy the committee.

We have in addition brought this legislation to the attention of our membership. We have with us a brief letter from the New York Public Service Commission, Arkansas Public Service Commission, and the Maryland Public Service Commission, which we would like to offer for insertion in the record.

Mr. DANIELSON. Is there objection? Hearing none, they will be received.

[The information follows:]

STATE OF NEW YORK,
PUBLIC SERVICE COMMISSION,
Albany, N.Y., July 18, 1979.

MR. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Washington, D.C.

DEAR MR. RABINOVITZ: I am writing concerning H.R. 229, a bill that would permit federal courts to issue declaratory judgment concerning controversies with respect to specified sections of the Internal Revenue Code that bear on ratemaking for public utilities. In my view, the purpose of the bill is desirable and important, but the bill as introduced can be improved upon. I also understand that the American Telephone and Telegraph Corporation is proposing certain amendments to the bill, at least one of which I consider to be highly objectionable.

The sections of the Internal Revenue Code at issue—26 U.S.C. § 46(*f*), 167(l), and 167(m)—are those under which the utility may lose certain tax benefits if its rates are set in a manner other than that specified in the statute. A celebrated instance of this phenomenon has occurred in California, where AT&T may lose considerable tax advantages as a result of certain actions taken by the California Public Utility Commission. As a general rule, we believe it improper for the Federal tax code to interfere in this way with the State regulatory process. Moreover, it can be well argued that these restrictions on State commissions impede, rather than advance, their goal of fostering investment in public utilities. (I have attached, for your information, a copy of a letter I wrote some time ago to Representative Rangel outlining this argument.) But as long as these sections of the code are not amended, I think it highly desirable that declaratory judgments be available as a means of dispelling any doubt about the effect on a utility's tax posture of particular ratemaking decisions. I therefore support, in principle, H.R. 229.

Under the bill, the only parties authorized to seek a declaratory ruling are the public utility and the ratemaking authority. This restrictiveness, I believe, is unwarranted. Intervenors in rate cases often advocate a particular rate treatment, and regulatory commissions frequently heed their recommendations. Accordingly, any party who has intervened and submitted testimony in a rate case should, I believe, be authorized to seek a declaratory judgment concerning the tax consequences of its recommendations. Of course, the public utility, the regulatory commission, and the Secretary of the Treasury should be joined as parties to the action.

Finally, I note with concern AT&T's proposed amendment to empower the Federal court before which a declaratory judgment is sought to "enjoin, suspend, or restrict the operation of any ratemaking order creating the controversy." This would constitute, in my view, improper interference with the State regulatory process. A means for resolving these controversies, should be available; but a State commission should, I believe, remain free to conclude that other considerations warrant imposing on the company the risk of losing the tax benefits in question.

If you wish to discuss our views on this subject further, please feel free to call or write to Peter H. Schiff, our general connsel; Eric A. Leighton, the director of our office of accounting and utility finance; or Joel A. Linsider, my executive assistant.

Sincerely,

CHARLES A. ZIELINSKI.

Enclosure.

ARKANSAS PUBLIC SERVICE COMMISSION,
DEPARTMENT OF COMMERCE,
Little Rock, Ark., June 18, 1979.

Mr. DENNIS DRABKIN,
Office of the Assistant Secretary for Tax Policy,
Department of the Treasury,
Washington, D.C.

DEAR MR. DRABKIN: A copy of H.R. 229 has recently come across my desk. Accompanying it was a letter saying that I should direct any comments to you. By basic comment is, this is not wise legislation.

This legislation just establishes another way to add to the already oversized caseload of U.S. District Courts. There is no special reason to accomplish that addition, since it cannot plausibly be argued that United States District Judges have greater competence in interpreting the Internal Revenue Code than do State court judges, or, for that matter, than do public utility commissioners. The bill further disregards normal Federal jurisdictional principles involving abstention and exhaustion of administrative remedies. Finally, H.R. 229 provides a method for subverting the normal appeal process which, when interpretation of federal statutes is involved, of course includes the U.S. Supreme Court. These problems I can recognize as a lawyer who has some experience in Federal practice.

As a member of this commission, I can recognize H.R. 229 as an attempt by AT&T to accomplish legislatively what has for good reason eluded it administratively and judicially. In short, this is just one more bad Bell bill.

Yours very truly,

N.M. NORTON, Jr., *Chairman.*

STATE OF MARYLAND.
PUBLIC SERVICE COMMISSION,
Baltimore, Md., July 26, 1979.

Mr. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy,
U.S. Department of the Treasury,
Washington, D.C.

Re: H.R. 229 a bill proposing to amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

DEAR MR. RABINOVITZ: After a brief review of H.R. 229, it appears that there is a need of some clarification in the bill particularly with respect to the extent of the Federal courts review of the State's rate making decision, and to any stay of State commission orders. The possibility of a stay of a commission order until resolution of a Federal action could be detrimental. Furthermore, this could provide the opportunity for improper use of this action.

Very truly yours,

THOMAS J. HATEM, *Chairman.*
(By RONALD E. HAWKINS,
Executive Secretary).

Mr. RODGERS. That concludes my statement, Mr. Chairman.

Mr. DANIELSON. Mr. Barnes.

Mr. BARNES. I will forego the opportunity. Let me just thank Mr. Rodgers for his very kind comments. I am not still a member, am I?

Mr. RODGERS. Yes, you are, once you are a member, always a member.

Mr. BARNES. I want the record to show I have a parochial interest.

Mr. DANIELSON. We are glad to have you here, too, Mr. Barnes.

Mr. McClory?

Mr. MCCLORY. After your executive meeting, you will communicate with the subcommittee?

Mr. RODGERS. Yes, sir.

Mr. MCCLORY. I understand your position about the injunction provision. Would you not likewise anticipate opposition of membership to the intervention of others in the proceeding because that would, in a sense, supersede or duplicate proceedings that you would have in the regulatory commission?

In other words, as I envision the IRS declaratory judgment proceeding, it is to determine tax liability for purposes of establishing figures or taxes. To include other interests, consumer interests or whatever interests that might be involved in such a proceeding would—well, it would impinge upon the role of the regulatory commission.

Mr. RODGERS. Yes, sir; and I do not think the amendment is necessary, because when a Federal court issues a declaratory judgment, it is going to be obeyed.

Mr. MCCLORY. Thank you very much.

Mr. DANIELSON. Mr. Kindness of Ohio.

Mr. KINDNESS. I will reserve judgment as to how happy we are to have you here after we receive information as to your position on this bill.

I say that facetiously, but we do appreciate your participation.

Mr. RODGERS. Thank you.

Mr. DANIELSON. Sir, I assume your office is right here in Washington and you are generally present, or Miss James is.

Mr. RODGERS. That is correct.

Mr. DANIELSON. I hope you will follow the hearings which will continue to be held on this and favor us with your comments. I do not imply we will follow them, but we would like to have them.

Mr. RODGERS. We appreciate your interest.

Mr. BARNES. May I make a specific request along those lines?

Mr. DANIELSON. Certainly.

Mr. BARNES. Mr. Chandler submitted certain recommendations from the point of view of the California commission. I wonder if it would be possible for NARUC to present its attitude with respect to those recommendations.

Mr. DANIELSON. I thank the gentleman for reminding me. I wish to state and I do state that I hope all interested persons will cooperate with us by letting us know their position on various items as they come up. If people have some suggestions as to amendments that might be appropriate, please supply them. We will consider them. We can use all the help we can get. That invitation is extended to all persons concerned.

There is a recorded vote pending which is on a substance matter, and I do believe we are going to have to attend. We did have another witness, Mr. Brian Lederer, People's Counsel of the District of Columbia.

Mr. Lederer, we cannot get to you this morning. We note you are a local; we will have more hearings, and since you have not had to travel a long distance to get here, I hope you will understand. We will call you back again, and you are always welcome to come by.

Thank you all. We will have more hearings on this matter commencing after Labor Day, and with the help of all concerned, I hope we can come to a proper solution.

The subcommittee stands adjourned.

[Whereupon, at 12:15 p.m., the subcommittee was adjourned, to reconvene upon the call of the Chair.]

TENNESSEE PUBLIC SERVICE COMMISSION,
Nashville, Tenn., September 18, 1979.

Hon. GEORGE E. DANIELSON,
Chairman, Subcommittee on Administrative Law and Governmental Relations, U.S. House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE DANIELSON: Thank you for your letter of September 10, 1979, to Chairman Z. D. Atkins. I attach hereto a copy of a letter dated August 15, 1979, that Commissioner Atkins sent to all members of the House Judiciary Subcommittee in regard to H.R. 229.

The Commission is opposed to H.R. 229, and we are also opposed to any stay while the matter is transferred to the Federal court for declaratory judgment. However, we do feel that if the bill is amended to expand the category of persons eligible to initiate the declaratory judgment proceeding, it should include all parties to any related ratemaking proceeding and not just the utility.

Mr. Paul Rodgers of NARUC is coordinating this matter for the various State commissions.

Thank you for your interest. If we can be of further service, please advise.

Very truly yours,

EUGENE W. WARD,
General Counsel.

Attachment.

TENNESSEE PUBLIC SERVICE COMMISSION,
Nashville, Tenn., August 15, 1979.

Mr. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy,
U.S. Department of the Treasury,
Washington, D.C.

In re: H.R. 229, a bill proposing to amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

DEAR MR. RABINOVITZ: The Tennessee Public Service Commission is opposed to H.R. 229 because it would have serious implications on our regulation of ratemaking authorities, particularly in telephone proceedings regarding accelerated tax issues. The bill as written does not limit declaratory judgment to tax questions. The rate-making impact could also be established by the Federal courts, and if H.R. 229 is enacted it should be specifically amended so as to be limited to interpretation of tax statutes so as to not to erode the States' traditional jurisdiction over rate making.

Also, the bill as written provides only that the affected utility or regulatory agency may seek a declaratory judgment. It should also authorize action by all necessary parties and intervenors such as the various cities in Tennessee or consumer groups that participate in Commission proceedings. It is my understanding that the bill will be amended so as to provide for a stay while the declaratory judgment matter is pending in Federal court. A stay provision would thus authorize real interference for State proceedings and is contrary to the Federal policies against interference with such proceedings.

For the foregoing reasons this commission is opposed to H.R. 229.

Sincerely yours,

Z. D. ATKINS, *Chairman.*

AMERICAN GAS ASSOCIATION,
Arlington, Va., August 10, 1979.

Chairman GEORGE E. DANIELSON,
House Committee on Judiciary, Subcommittee on Administrative Law and Governmental Relations, Rayburn House Office Building, Washington, D.C.

DEAR CHAIRMAN DANIELSON: I would like to take this opportunity to request that the attached statement of the American Gas Association (A.G.A.) be incorporated in the record of the proceedings with respect to H.R. 229, a bill to amend the United States Code to provide for declaratory judgment in certain cases involving public utilities.

Chairman Danielson, I extend my personal thanks for providing A.G.A. this opportunity to express our views on your bill, H.R. 229.

Sincerely.

GEORGE H. LAWRENCE.

Attachment.

WRITTEN STATEMENT OF THE AMERICAN GAS ASSOCIATION

On behalf of the American Gas Association (A.G.A.), we are pleased to indicate the general support of our industry for Congressman Danielson's bill H.R. 229, which would amend title 28 of the United States Code, and provide for a declaratory judgment procedure in certain tax cases involving public utilities. A.G.A. is a national trade association which represents over 300 natural gas transmission and distribution companies serving over 160 million natural gas consumers in all 50 States. A.G.A. members account for approximately 85 percent of the gas utility sales in the United States.

The investment tax credit, accelerated depreciation, and the class life ADR system have been used by the natural gas industry consistent with congressional intent underlying these provisions. In brief, it was generally expected that a part of the tax benefits conferred by these provisions be used by the utility to stimulate plant investment and to update plant facilities. In some instances, however, there have been differences of opinion among the utility, its regulatory commission, and the Internal Revenue Service as to the permissible treatment of the tax benefits in the determination of customer rates. Under present provisions of law, a great deal of time—even years—may elapse before a final determination is reached. In this interim period, the utility is faced with financial contingencies that have a substantial negative effect on its financing, construction, and operations in the energy field. Such uncertainty is addressed by H.R. 229.

Essentially, H.R. 229 recognizes the problem created by the uncertainty arising from these differences in opinion as to application of Sections 46(f), 167(l), and 167(m) of the Internal Revenue Code. The bill, however, would not restrict in any way the actions or policies of the regulatory commissions. Rather, H.R. 229 would provide for a declaratory judgment by a Federal district court on the issue of a public utility's entitlement to the investment tax credit and depreciation. This determination would be binding on the public utility and the Internal Revenue Service for purposes of deciding an actual controversy which arises with respect to the denial of these tax benefits by the Service because of the accounting treatment required for such tax benefits by the regulatory commission. At present, any such determination is available only after the Internal Revenue Service audits the taxpayer and assesses a deficiency if it believes the regulatory commission is improperly requiring the utility to flow through the benefits. The declaratory judgment procedure provided by H.R. 229 would expedite the ultimate determination of whether the tax benefits would be lost to the utility under the code so that both utility and the regulatory commission could be certain of the tax consequences of the commission's actions.

While A.G.A. generally supports H.R. 229, we would like to offer two specific comments on the bill. First, it is important that the term "public utility" in section 2 of H.R. 229 be defined to insure that both natural gas distribution and transmission companies are included. The term "public utility" should be defined by specific reference to Section 118(b)(3)(C) of the Internal Revenue Code.

Second, H.R. 229 would provide for a declaratory judgment procedure only in the case of controversies with respect to sections 46(f), 167(l), and 167(m) of the Internal Revenue Code. Since legislative proposals are pending regarding revisions of capital recovery mechanisms (viz., Capital Recovery Act of 1979, H.R. 4646 by Congressmen Jones, D.—Okla., and Conable, R.—N.Y.), A.G.A. submits that the declaratory judgment procedure granted by H.R. 229 should also be available in any controversies with respect to the regulatory treatment of tax benefits from any such future capital recovery incentives. A.G.A. suggests that H.R. 229 be so modified.

A.G.A. wishes to express its appreciation for this opportunity to present its views on this matter.

DECLARATORY JUDGMENT IN CERTAIN CASES INVOLVING PUBLIC UTILITIES

WEDNESDAY, SEPTEMBER 12, 1979

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE JUDICIARY,
SUBCOMMITTEE ON ADMINISTTRATIVE
LAW AND GOVERNMENTAL RELATIONS,
Washington, D.C.

The subcommittee met at 9:30 a.m. in room 2226 of the Rayburn House Office Building, Hon. George E. Danielson (chairman of the subcommittee) presiding.

Present: Representatives Danielson, Mazzoli, Hughes, Harris, and Moorhead.

Staff present: Messrs. Shattuck, Lauer, and Coffey; Ms. Potts and Ms. McGrady.

Mr. DANIELSON. The hour of 9:30 having arrived, the subcommittee will come to order.

We will continue today with hearing testimony on the bill H.R. 229, to amend title 28 of the United States Code to provide for a remedy of declaratory judgment in certain cases involving public utilities. This will probably be our last day of testimony on this bill, although that is not a firm commitment at this time.

Today we are going to hear from the Honorable Daniel I. Halperin, Assistant Secretary of the Treasury for Tax Legislation; from Mr. Burt Pines, city attorney of Los Angeles, Calif.: Mr. George Agnost, the city attorney of San Francisco; Mr. John Witt, city attorney of the city of San Diego; Mr. Brian Lederer, attorney for the People's Council of the District of Columbia; Miss Janice E. Kerr of the California Public Utilities Commission; and a followup bit of testimony from Mr. Robert Dalenberg, vice president and general counsel of Pacific Telephone & Telegraph Co.

I understand that Mr. Halperin has an almost immediate appointment elsewhere, so we will hear from you first, Mr. Halperin. I understand you have submitted a written statement.

Mr. HALPERIN. Yes, Mr. Chairman, I have.

Mr. DANIELSON. Without objection, that will be received in its entirety into the record, and you're now free to proceed in any manner that you choose.

[The complete statement follows:]

STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY OF THE TREASURY (TAX LEGISLATION)

Mr. Chairman and members of the subcommittee, I am pleased to have this opportunity to present the views of the Treasury Department on H.R. 229, a bill to provide a declaratory judgment procedure to determine whether certain

public utility rate orders comply with the Internal Revenue Code normalization requirements.

In a bill report sent to the Chairman before the first bearing on August 2nd, the Treasury expressed its strong support for the general policy against declaratory judgments in tax matters. We nonetheless conceded that tbere are exceptional situations in wbich a declaratory judgment is the only effective relief. Since bowever, declaratory relief in tax matters is an extraordinary remedy, tbe burden is on those who would see it extended to demonstrate that such relief is needed. We wished to take no position on H.R. 229 until its proponents bad been given the opportunity to make that case. We hoped that the testimony of other witnesses would clarify the precise nature of the problem and the reasons why declaratory relief was the only effective solution.

The testimony on August 2nd was indeed extremely helpful. For reasons upon which I shall elaborate, we feel that the testimony, requires the conclusion tbat extension of the extraordinary remedy of declaratory relief to this situation, would be unnecessary and unsound. We tberefore oppose H.R. 229.

To understand why requires a brief explanation of the reasons for the long-standing Congressional policy against declaratory judgments in tax cases. That policy is founded on 3 related principles: (1) reluctance to decide cases before the facts bave been fully developed; (2) avoidance of excessive litigation; and (3) reliance on a voluntary compliance system of tax administration. Let me discuss each of tbese briefly.

By refusing to decide tax cases in advance, we assure that cases will be decided on a full record, developed on the basis of facts as they actually occurred. This assures that decisions are reached witb a full appreciation of bow the legal principles apply to the particular facts. Since this policy also assures that the same case will not have to be relitigated when the facts turn out to be somewhat different from those originally supposed, it is closely related to the policy of avoiding excessive litigation. A declaratory judgment proceeding to determine tbe compliance of rate orders wbich are not yet effective, and whicb are subject to modification by state courts, presents the very possibilities of subsequent changes and repeated litigation which the anti-declaratory judgment policy seeks to avoid.

The anti-declaratory judgment policy also prevents the excessive litigation which unquestionably would result if taxpayers were permitted to litigate in advance every uncertain tax question. Our tax law must deal with an infinite variety of situations and transactions, limited only by what sometimes appears to be the boundless imagination of taxpayers. A law which must deal wtib such variety and complexity can not provide certainty in every instance. The Internal Revenue Service ruling process is designed to ameliorate the problems of uncertainty, by providing taxpayers with the opportunity to obtain advance clarification of tbe tax law in non-disputed areas. Not every potential dispute, tbe great majority of which never mature, can be resolved in advance by the courts. The anti-declaratory judgment policy expresses the Congressional judgment that the District Courts can not be permitted to become the final step in the Internal Revenue Service ruling process.

The third policy underlying the anti-declaratory judgment policy derives from the nature of our self-enforcement system of tax administration. Taxpayers are clearly entitled to guidance in finding a safe course, consistent with the spirit of tbe law, which will he immune from IRS attack. Requiring in every case, however, advance delineation of the precise line between compliance and non-compliance, would subject the system to unbearable pressure. Only hy requiring that those who would test the limits of the law accept the risks of overstepping is this pressure kept within tolerable bounds.

The application of this principle to the present case is evident. The Internal Revenue Code normalization requirements have thus far produced little controversy. As far as we can tell, there has been a high measure of voluntary compliance. This is to be expected, since the cost of noncompliance is substantial. There are, however, any number of conceivable ways of accounting for tax subsidies. Between pure normalization at one end of the spectrum and pure flow through at the other, the possibilities are numerous. Congress could not possibly have addressed specifically every such possibility. It did instead the one thing it could do to insure that the normalization objective would not he undermined—it imposed severe consequences on those who departed too far from the norm. The Congressional purpose in mandating normalization would he jeopardized, however, if a declaratory judgment procedure enabled regulators, without risking the consequences, to determine in advance just how much of a departure will be

tolerated. If a declaratory judgment procedure were available, we believe that the political pressure for some type of flow through would virtually force even the most conscientious of regulators to do precisely that. Since a ruling from the Internal Revenue Service is a prerequisite to commencement of a declaratory judgment proceeding, the result would be an enormous increase in the burden on the IRS of administering the normalization provisions, and, what is far more important, inordinate pressure on the rules themselves.

We are not intransigent. In the past, where circumstances have seemed compelling, we have supported exceptions to the anti-declaratory judgment policy in tax matters. The situations in which we have done so are discussed in our bill report. The question now to be answered is whether the normalization requirements for utility rate orders present another problem, for which, notwithstanding some objections, declaratory relief is the only effective solution. We believe that the information developed at the hearings requires a negative answer to this question.

We do not deny that Pacific Telephone and General Telephone, faced with enormous tax deficiencies, are in an extremely unfortunate position. The testimony, however, has been unanimous, that this legislation, if passed, will be of absolutely no help in the present dispute, at least in so far as past years are involved. The parties have agreed that neither the Public Utilities Commission nor the California courts can retroactively modify the rate order, even if it is determined to be in violation of the Internal Revenue Code normalization provisions. The damage, if any, to the phone companies has already been done, and a declaratory judgment proceedings can not help.

Although a declaratory judgment proceeding can not help with respect to past years, it is within the power of the Public Utilities Commission to mitigate any harm which has been done. While the Commission can not retroactively modify its rate order to regain for the phone companies any tax benefits which may have been lost, it can prospectively permit the tax deficiency, and the cost of any interim borrowing necessary to pay it, to be recovered from customers in the form of higher rates. Since these higher rates could be offset at least in part by the refund which is otherwise required under the California rate order, the disruption to ratepayers can also be ameliorated. It is therefore, within the power of the Commission to protect the utilities and their stockholders from the potential economic hardship produced by the loss of tax benefits under the Commission's rate order.

With respect to the future of this particular controversy in California, we have been told that the Pacific Telephone audit for 1974 is about to be concluded. The normal tax appeals process will therefore be available to resolve the dispute. Once the tax appeals process begins, there is no reason to believe that it will not proceed as rapidly as the proposed declaratory judgment proceeding. Particularly if intervenors are permitted in the declaratory judgment action, it is likely to become a protracted, time consuming proceeding. And the intervenors may be indispensible parties, since not infrequently it is they and not the commission themselves who are the true proponents of the questionable accounting methods. Thus, failure to permit intervention could destroy the only true adversary relationship, while permitting it could invite self-defeating delay.

A declaratory judgment proceeding might nonetheless be thought warranted, if it could avert, either in California or elsewhere, similar controversies in the future. At the August 2nd hearing, the question was raised as to whether the doubt expressed by the Justice Department as to whether even substantial tax deficiencies would produce a nationwide economic disruption—a doubt which we share—was inconsistent with the position taken by the government in urging the Supreme Court to grant cert in the California proceeding. The reason there is no inconsistency is closely related to the reason we feel a declaratory judgment proceeding is not here necessary. The financial upheaval which the government apprehended in its brief to the Supreme Court was based upon the premise that other jurisdictions would follow California's lead. The hearings have revealed, however, that similar controversies have not arisen in other jurisdictions, and that in Maine, the one jurisdiction in which the public utilities commission was tempted to run similar risks, the courts intervened.

In sum, the hearings have revealed that the proposed legislation can do little to help in the present dispute, and that, at the present time, there appear to be no similar disputes pending for which such a procedure would be necessary. It is argued nonetheless that such a declaratory judgment procedure should be available, because similar disputes could arise. Pacific Telephone predicts that numerous other states, under pressure to lower rates, are likely to adopt meth-

ods of accounting for accelerated depreciation and the investment credit similar to California's. Yet other jurisdictions have, thus far, apparently been unwilling to run such a risk. Moreover, other state regulatory commissions, in attempting to discharge their responsibility by fashioning rate orders which comply with the Code normalization requirements, have not felt the need for declaratory assistance. Although we understand that NARUC is now supporting some form of declaratory relief, most of the commissions which have expressed their views to us are strongly opposed to this legislation. Their position thus confirms the inescapable message which emerges from the testimony at the August 2nd hearing—namely that the California situation is indeed unique.

Despite the absence of a compelling case for a need for a declaratory judgment proceeding, we would not be urging you to reject this legislation if we felt that it would do no harm. We urge its rejection because, for the reasons discussed previously, it would create the very situation which the anti-declaratory judgment legislation is intended to prevent. Until now, most jurisdictions appear to have complied with the Internal Revenue Code normalization proceedings. No doubt this compliance has in large part been attributable to the fact that the costs of the failure to comply can be substantial. Given the political pressure for some form of flow through, it seems almost inevitable that, with a declaratory judgment proceeding permitting risk free probing of the boundaries of the normalization requirements, almost every jurisdiction would be compelled to attempt some hybrid accounting method. The result would be numerous lawsuits in what has heretofore been a relatively controversy free area, and a testing of the limits of the Internal Revenue Code normalization requirements which those provisions may be unable to bear. For these reasons we are opposed to a declaratory judgment relief in this area.

Before closing, I would like to comment upon one specific of the proposed legislation which, we feel, should in any event be changed. I refer to the exclusive jurisdiction in the District Courts. In every other case in which a declaratory judgment has been authorized in tax matters, the Tax Court has been given at least concurrent jurisdiction. The question of compliance requires the interpretation of exceedingly technical and complex provisions of the Internal Revenue Code. Jurisdiction should be extended to the Tax Court to assure access in normalization cases to the judges having the greatest technical expertise in tax matters.

SUMMARY

Although we have supported exceptions, we strongly support the policy against declaratory judgments in tax cases.

That policy is based upon three related principles: litigating only on a fully developed record, avoiding excessive litigation and maximizing compliance with the purpose of the substantive rules. All three principles are jeopardized in the present situation.

Declaratory relief might nonetheless be appropriate if it were the only effective solution to a current or impending problem. It appears, however, to offer little hope of relief in the current California situation. Moreover, no similar situations appear imminent. Passage of this legislation, on the other hand, would precipitate additional disputes. Therefore, we are opposed to H.R. 229.

In the event that H.R. 229 is nonetheless acted upon favorably, we believe that jurisdiction should be extended to the Tax Court, the court having the greatest expertise in the interpretation of the Internal Revenue Code.

TESTIMONY OF HON. DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY FOR TAX LEGISLATION, U.S. DEPARTMENT OF TREASURY, ACCOMPANIED BY JOEL RABINOVITZ

Mr. HALPERIN. Thank you, Mr. Chairman. I appreciate your letting me proceed first at this hearing. I do have to be at the Ways and Means Committee very shortly. With me is Joel Rabinovitz of the Office of Tax Legislative Counsel.

Mr. Chairman, this has been a very difficult issue for us to resolve, but we have decided that we should oppose H.R. 229. And let me briefly indicate the reasons for that conclusion.

We first believe that the policy against allowing declaratory judgments in tax actions generally is a sound policy. On the other hand, we do believe that an exception could be made in this case, which wouldn't necessarily extend to all tax actions. There is substantial potential harm to the utilities in this case, and the utilities are forced to take the risk of potential tax liability against them because of actions by the regulatory commission and the State court.

However, on balance, we do not feel that the declaratory judgment is a solution. What needs to be done here to help the situation in California is to resolve the question as to whether the accounting treatment prescribed there is consistent with the Internal Revenue Code, as quickly as possible. While we recognize that there is some difference of opinion between us and the phone companies on this issue, we do not see the declaratory judgment as being a significantly faster method of resolving the current difficulty.

The audit of the phone companies for 1974 is about over. They can be in the Tax Court very quickly. We are prepared to cooperate to expedite the Tax Court hearings, to make them go as quickly as possible. There are procedures available within the Tax Court to help make sure that the fact that there may be additional issues in the case will not unduly delay the procedure.

We have no reason to believe that a declaratory judgment action in the district court would move significantly faster. There has been interest as part of this legislation to permit intervenors to participate in the declaratory judgment action, and I think it is clear that the more parties involved, the slower it is likely to be. So we think that in terms of getting a decision as to whether the accounting procedure prescribed by the California court in this case is consistent with the Internal Revenue Code, the normal Tax Court action will be no slower than the declaratory judgment action.

Now, that may have been different if a declaratory judgment had been available 2 or 3 years ago. And therefore it does raise a question as to whether the existence of a declaratory judgment procedure can reduce the potential damage in future disputes. I think it is possible that it could, but we have a serious question about the impact of the existence of a declaratory judgment procedure on the number of disputes that are likely to occur.

For example, if in this particular case Tax Court findings upholding the Internal Revenue Service that the accounting procedure prescribed herein is improper, would settle it, so that no other State commission would try to come up with a means around the normalization requirement, then there is no need for any procedures because this matter will go away quietly.

If it doesn't settle it, the question to us is, which way are there likely to be further cases? If you have to compare two situations right now in order to take a chance on what might appear to be a flowthrough procedure, the commission would have to subject the utility to the risk like the one now imposed on Pacific Telephone in California.

On the other hand, if there were a declaratory judgment procedure, there would be a relatively risk-free way of testing the precise limits of the Internal Revenue Code in this area.

And we think if that were available that there are just more likely to be disputes raised, more likely to be controversies over the exact

meaning of the Internal Revenue Code. We think this points out the general reasons why we disallow declaratory judgment in tax cases.

Mr. DANIELSON. I don't think you do. Isn't it the law that disallows them? You know, the Internal Revenue Service as many other bureaus sees to feel it is the fountainhead of justice. It isn't, it just works with it.

Mr. HALPERIN. Excuse me, Mr. Chairman, I mean why the law disallows declaratory judgments in tax cases. It's clear that the Public Utility Commission of California and the California court can, without great difficulty, adopt a method that does comply with the code, and they can get rulings from the Internal Revenue Service if they have substantial questions. Just as most taxpayers have, they have available a course of conduct which is free of difficulty and which is consistent with the congressional intent in this area.

However, it may not be clear how far they can go, what the precise limit of the law is. I think it is clear that in a tax law as complex as this one, which affects so many situations and so many people, that the law just cannot provide that kind of certainty. We cannot always give the answer as to what the exact line is between compliance and noncompliance with the law. The risk that is involved in trying to get right up to the line will prevent most taxpayers, or at least many taxpayers, from trying to get too close. They will adopt the safer course, or, if they do get into controversy with the Internal Revenue Service, the cases are generally settled without reaching the trial stage.

But if you can find out beforehand, if you can ascertain what the precise line is, then with the amount of dollars involved in this case and the amount of pressure from various groups to try to find a way to flow-through the tax benefits, we believe that the commissions may be tempted to try it, and that there will be a multiplicity of litigation in this area.

We are afraid that the system just really cannot stand it. Normalization requirements of the Internal Revenue Code have, with the exception of the California case, been largely self-enforcing. We think that this is the only way it really can work. Congress, in 1969 and in 1971, imposed these nomalization requirements because there was concern that the regulatory commissions subject to the pressure for flow-through were defeating the purposes of the investment credit and accelerated depreciation, which were intended to make more funds available for capital investment by utilities and other businesses. They were defeating the purpose by immediately using them to reduce the charge for utilities' services.

Therefore, Congress felt that it ought to mandate the method of accounting to be followed if these tax benefits were to be available. On the other hand, we must recognize that we are getting the United States involved in an area which is generally a State concern, regulation of utility rates, and in particular we're getting the Internal Revenue Service, which has no particular expertise in ratemaking, involved in that very delicate area.

If we are going to have constant testing of the precise limits of that area, it seems to us very doubtful that the IRS would be equipped to deal with it, and that may put into question whether the entire procedure can stand up under that pressure.

In summary, we are saying that we think the existence of H.R. 229 will not substantially reduce the time that will be required to get a

final answer in the California situation. Second, we think it will increase the likelihood of disputes in other States, which up to now have not taken place. And it is for those two reasons that we have felt that we should oppose the bill.

If we can be persuaded that we are wrong on either or both of those premises, we are obviously open to reconsider our opposition. But from what we have heard up to now, we believe we are correct in these judgments.

Mr. DANIELSON. Thank you very much, Mr. Halperin. I will yield to my colleague, Mr. Moorhead of California, for questions.

Mr. MOORHEAD. What would you think about directly amending the Internal Revenue Code, rather than this amendment to title 28, to to take care of the problem?

Mr. HALPERIN. In the same manner, to provide for declaratory judgment action?

Mr. MOORHEAD. Well, it could be done that way, or you could work out another way that would be more amenable to the systems that the various States have.

Mr. HALPERIN. Well, I guess without more of an indication of exactly what you have in mind, I'm not sure I can answer the question. I think if it ends up with a declaratory judgment procedure, we would have the same opposition.

Mr. MOORHEAD. We obviously have a problem here that is causing a lot of difficulty, and we have got to find a solution for the problem. This bill is one solution that has been recommended for the problem. You don't like this solution, but what solution would you follow instead?

Mr. HALPERIN. Well I think, Mr. Moorhead, one real question is whether the problem will continue, whether this is an aberration which will disappear once this tax case is finally settled, or whether we will have other States which will try different kinds of accounting methods in order to come closer to what seems to be a flow-through method of accounting.

We are at least proceeding on the assumption that it is possible that once this dispute is settled that others will not follow, and therefore we think that this bill will be unnecessary. It may increase the likelihood that we may have more trouble in the future. We are at least hopeful that once this case is settled we will not need additional machinery, because others will not be tempted to try what the California courts and the California commission have tried.

If we are wrong about that, if other States will try nevertheless, then I think you are right, that we have to find some other procedure to mitigate the potential damage that is caused by a problem of this kind. But I think we are starting, as I said, from the premise that this case cannot be helped by this legislation—and I think we ought to look for—to look into possible ways, assuming that the IRS is successful and wins the tax case, of mitigating the potential damages.

Certainly, it is not particularly sensible to collect that kind of deficiency from A.T. & T., which they estimate is approaching perhaps $3 billion by 1983. No one's purposes are served by that occurring, and perhaps we ought to explore ways of mitigating the potential damage to the utility and to the California consumers, assuming that this case—or if this case is eventually won by the Internal Revenue Service.

Mr. MOORHEAD. Well, if I heard your testimony correctly, you said that this would be followed by California adjusting its accounting system to meet the requirements of IRS. But isn't the company and their customers and their stockholders all caught in between two major governmental agencies that just don't seem to be able to get together to adjust these things?

Mr. HALPERIN. There's no question about that, Mr. Moorhead. They have been, and I think that is a troubling situation. On the other hand, we don't want to see that kind of thing proliferating, and up till now it hasn't. It has been limited to one State. There was a start at it in Maine but the Maine Supreme Court cut it down.

We are troubled at the existence of a declaratory judgment procedure, that it may increase litigation substantially without helping in the particular case that we're all worried about. This one has gone too far for a declaratory judgment procedure.

Mr. MOORHEAD. Well, it probably wouldn't work now, but if we have the declaratory judgment procedure under H.R. 229—if it had been available, could this problem have been avoided?

Mr. HALPERIN. I think if the declaratory judgment procedure had existed 3 years ago or 2 years ago, when this dispute first reached the court, the problem may have been avoided, assuming that all parties were willing to delay the position of the order until the court case could be settled.

Mr. MOORHEAD. Well, my time is just about up, but I just wanted to ask one last question.

Do you have any other suggestions that we might use, where the Congress can be effective or helpful in avoiding problems like this in California, or helping to solve this particular problem?

Mr. HALPERIN. Well, I think that we need to consider the possibility of whether or not there is some way of avoiding the damage that might occur to the utilities and to its customers if the current tax case goes through to completion with a decision that the Internal Revenue Service ruling policy was correct, and that they're not under present law entitled to the tax benefits.

I think that is something that needs to be considered, and I think that if we are wrong in our assumption and other States begin to try other accounting procedures that appear to violate the tax rules, then I think we would have to reconsider our opposition to this legislation.

Mr. MOORHEAD. Thank you very much.

Mr. DANIELSON. Mr. Mazzoli of Kentucky.

Mr. MAZZOLI. Mr. Chairman, I have no questions.

Mr. DANIELSON. Thank you. Mr. Halperin, I see you are accompanied by a gentleman. Would you state his name and title?

Mr. HALPERIN. That is Joel Rabinovitz of the Office of Legislative Tax Counsel in the Department of the Treasury.

Mr. DANIELSON. Thank you. I realize that the Internal Revenue Service has a very great responsibility and obligation to collect the funds called for by law, in order that the Government can function. And obviously, along with that, you have the obligation to eliminate as many imperfections as you can so that you have a maximum efficiency in collecting the revenue.

I am disturbed here by the fact that a taxpayer, in this case Pacific Telephone, is being exposed to a monumental risk that is a catch-22

type situation. Politicians call it a no-win situation. No matter which way you go you are going to have some kind of trouble down the line. How do you justify exposing the taxpayer to this kind of risk?

Mr. HALPERIN. Well, as I said initially, the fact that Pacific Telephone is being forced to take the risk without—or against its own volition, I think distinguishes this case from a lot of others and is the reason why one has to think seriously about whether a declaratory judgment procedure makes sense. I think of course it is the commission that is causing Pacific Telephone to take the risk. Or it is the commission and the California court. There is no doubt that it can develop an accounting procedure which applies with the requirements of the Internal Revenue Code, and avoid that risk.

This is not a case in which, in effect the commission is saying, we don't know what the right rules are and until somebody tells us we have to guess and therefore we have to create a problem for the taxpayer. That is not what is happening here. It can no doubt devise an accounting system which clearly complies with the Internal Revenue Code.

On the other hand, they are trying to reduce current utility rates as much as they can.

Mr. DANIELSON. May I interject? I'm not an expert in this field, but as I understand it, if they do devise the accounting system that you describe so that they can comply with the Internal Revenue Code and get the benefits of accelerated depreciation and investment credit, then they would be required, under the revenue laws, to utilize that benefit for capital improvement; would they not?

Mr. HALPERIN. Yes, Mr. Chairman.

Mr. DANIELSON. How can they do that, then, if the utility commission says, Fine you, saved some money on depreciation but now you've got to use that against the rate base, to reduce consumers' rates. Isn't that the situation?

Mr. HALPERIN. That is basically the situation.

Mr. DANIELSON. So if they do use it to reduce rates, then they don't qualify for the accelerated depreciation.

Mr. HALPERIN. That is correct.

Mr. DANIELSON. This is a no-win situation. I don't know how on earth they can be expected to comply. Now, I want to restate that I understand and respect your obligations under the revenue laws. But I don't see how we can afford to expose a taxpayer to this kind of risk.

Mr. HALPERIN. Well, Mr. Chairman, the Internal Revenue Service is really in an unusual position here. It is not really functioning as a tax collector. What we have here is a subsidy to investment. Take the investment credit because it is simpler to look at. If a particular piece of equipment would normally cost $100,000 you get, in effect, a tax cut of $10,000 which would reduce the cost of the equipment to $90,000, 90 percent of its market cost. If that kind of subsidy would come from the Commerce Department rather than from the Internal Revenue Service, it would be easier to see what is happening.

But what we have is the Government saying, if you go out and buy a piece of equipment, we will give you 10 percent of its cost provided you don't take that $10,000 that we're going to give you and immediately reduce rates. And I think if the Commerce Department were administering a program, or if this were a grant program out of

HUD or HEW they would basically see that you don't get it unless you use it the way you're supposed to use it. And that is our obligation.

Now, we have a situation here where the California commission, at least in our view, is telling the utility to use it in the wrong way, and I think that is where the dispute comes from.

Mr. DANIELSON. Sir, I understand that and I am not quarreling with you but, of course, if I were talking to the PUC, they would be telling me that they think that you people are doing it the wrong way. And isn't that really the controversy that we have?

Mr. HALPERIN. I think that is correct, Mr. Chairman. And the question is really whether a declaratory judgment procedure will help us out of that dilemma.

Mr. DANIELSON. If you would put this on the analogy of torts, the two tort feasors happen to be the Public Utilities Commission and the IRS and the poor little guy in the middle is the telephone company. He's not very poor and he's not very little, but he is still in the middle.

I don't know how we're going to resolve this, but we will resolve it.

Mr. HALPERIN. Well, I think that the interest that we all have is to try to get the answer, a definitive answer to this question as quickly as possible, and to try to make sure that we don't get into this kind of trouble again in the future. And I think we just have a difference of opinion as to whether this legislation will move in that direction.

We don't claim to be infallible, but our guess is that it will move in the wrong direction.

Mr. DANIELSON. What makes you think that this wouldn't come up again in a similar type of case?

Mr. HALPERIN. Well, I think that, for one thing, it hasn't come up anywhere else for 10 years. Second, there are substantial risks involved if you do try this and I think that in many cases the State courts and the commissions will not want to take the risks that are being imposed upon A.T. & T. in California. I think this is a rather peculiar situation. I think one has to go back and look at what happened prior to 1969. The California commissions and the courts there were trying to get the utility to use flow-through and accelerated depreciation and the utility refused to do so. It refused to take accelerated depreciation if it was going to be required to flow through the benefits.

When the commission said, we will treat you as if you were doing it anyway, the utility, in effect, went to Congress in 1969 legislation—that came mainly at the instigation or the request of A.T. & T. and it grew out of the California situation. So there is a kind of war going on out there which I think is peculiar and I think the evidence shows that other States are not going to go down this line.

Mr. DANIELSON. Well, California is always, of course, the bellwether of the States, contrary to, as Maine goes so goes the rest of the Nation. I think it is just in reverse. You see Maine dropped their case. Back in my salad days I did a little tax work and I recall that many taxpayers took the position that the risk sometimes was so great that if you could come up with a settlement that you could at least live with—you might not live well, but you could survive—you took it rather than run the risk.

It illustrates the old axiom—who wants to test the electric chair? I think the revenue often depends upon that risk factor.

Mr. HALPERIN. I think we agree. I think the system cannot function if everybody were entitled to a precise answer as to how far they could go.

Mr. DANIELSON. If you're dealing with a situation of a relatively small amount of dollars, that's one thing, but there is a tremendous amount of money involved in this situation and I am frankly troubled about what we ought to do. I don't know what we are going to do. We will try to do it as well as possible. I would say, first, don't worry about the intervenors. This committee can put them in or it can leave them out. And I appreciate you would be opposed to including intervenors as parties in the event this became law; is that correct?

Mr. HALPERIN. Yes, sir.

Mr. DANIELSON. Don't worry about them, we can handle that one way or the other.

Mr. Hughes of New Jersey?

Mr. HUGHES. No questions.

Mr. DANIELSON. Thank you very much, Mr. Halperin. We may be in touch with you for some more assistance, but right now you are free.

Mr. HALPERIN. Thank you very much.

Mr. DANIELSON. Our next witness will be the Honorable Burt Pines, city attorney for the city of Los Angeles, who is accompanied today by Mr. Edward Perez, deputy city attorney.

Mr. AGNOST. Mr. Chairman, if you please, I am George Agnost, city attorney for the city of San Francisco. We are making a joint presentation with Mr. Burt Pines from Los Angeles and Mr. John Witt, city attorney from San Diego.

Mr. DANIELSON. So, you are having a tri-part type presentation. I think that is fine. Why don't you all come forward? Are you sure you have no conflicts of interest? [Laughter.]

TESTIMONY OF BURT PINES, CITY ATTORNEY, CITY OF LOS ANGELES, ACCOMPANIED BY EDWARD PEREZ, DEPUTY CITY ATTORNEY; GEORGE AGNOST, CITY ATTORNEY, CITY AND COUNTY OF SAN FRANCISCO, ACCOMPANIED BY LEONARD SNAIDER, DEPUTY CITY ATTORNEY; AND JOHN W. WITT, CITY ATTORNEY, CITY OF SAN DIEGO

Mr. PINES. Thank you, Mr. Chairman, We felt we might be able to save the committee time by dividing up the testimony ourselves. We have been together in these rate cases over the years.

Mr. DANIELSON. Burt, just a second, we have a reporter. Now that the record may be intelligible can I have names and identities from left to right clockwise starting with the gentleman on the reporter's left?

Mr. SNAIDER. My name is Leonard Snaider. I am with the city attorney's office in San Francisco.

Mr. AGNOST. George Agnost, city attorney from San Francisco.

Mr. PINES. I am Burt Pines, city of Los Angeles.

Mr. WITT. I am John W. Witt, city attorney for the city of San Diego.

Mr. PEREZ. And I am Ed Perez. I am with the city attorney of Los Angeles.

Mr. DANIELSON. Fine, I just wanted the record straight. Now, go ahead and proceed.

Mr. PINES. Mr. Agnost is going to commence.

[Complete statement follows:]

STATEMENT OF GEORGE AGNOST, CITY ATTORNEY, CITY AND COUNTY OF SAN FRANCISCO, CALIF.

The cities of San Francisco, Los Angeles, and San Diego oppose H.R. 229 for the following reasons.

1. The cities seek to insure that our citizens do not pay excessive utility rates.

2. H.R. 229 is special interest legislation designed to enjoin judicially affirmed refunds and rate reductions to customers of General Telephone and Pacific Telephone. Utilities in California or anywhere else are not impacted by the legislation.

3. The telephone companies' specter of lost tax eligibility, as presented in testimony to this committee, was contrived to escape refunds to customers.

4. No basis exists to permit Pacific and General to escape their judicially affirmed refund obligation.

5. Additional analysis of the defects of H.R. 229 and the background of the refunds and rate reduction obligation of General Telephone and Pacific Telephone is made in the statements of Burt Pines, city attorney of Los Angeles, and John Witt, city attorney of San Diego.

My name is George Agnost. I am the city attorney of the city and county of San Francisco. I was elected to that office in November 1977. I appear here today with Burt Pines, the city attorney of Los Angeles, and John Witt, the city attorney of San Diego. We are making a joint presentation in opposition to H.R. 229.

The cities oppose H.R. 229 and view it as nothing more than an attempt by the Bell System to enjoin judicially affirmed refunds and rate reductions to intrastate phone customers. Not only, under H.R. 229, may these rate reductions possibly be enjoined in the Federal courts, but the Bell System legislation will even preclude cities who successfully won these rate reductions and refunds in various court actions from being parties in Federal court action where they may be enjoined.

In this presentation, I will briefly explain the interests of the cities in intrastate rate proceedings and attempt to distinguish the intrastate rate issues from the Federal tax issues.

Mr. Pines and Mr. Witt will describe in detail the history of the intrastate rate litigation that has led the Bell System to seek H.R. 229 and provide a detailed analysis of the defects in H.R. 229, emphasizing our opposition to any interference with the intrastate rate process and describing that the instant issue of intratate rates is a narrow issue limited to California which should not justify broad Federal legislation opening the declaratory judgment statute.

CITIES' INTEREST

The cities of San Francisco, Los Angeles, and San Diego are extremely active before the California Public Utilities Commission and on occasion before Federal regulatory bodies in the public utility ratemaking area. This is not a new consumer fad for the cities. Our offices have been engaged for many, many years in appearing before regulatory bodies to insure just and reasonable rates. Our interest is twofold. City government faces major expenditures for utility services. San Francisco, the smallest of the cities appearing before you today, has a telephone bill in the magnitude of $2,750,000 a year. More important than our own governmental costs of utility service, every one of our citizens is virtually required to use utility services. We view it as our duty to see that our citizens are not overcharged.

The State Public Utilities Commission is sometimes unable to fully protect the interest of the citizens of our Cities. When the Commission is wrong only the Cities have the practical ability to seek reversal in the courts. Mr. Witt will show that we have been extremely successful litigants and have won rate reductions and refunds for our citizens by overturning excessive rate orders. Some of these refunds and reductions may be threatened by H.R. 229. In concluding this point, we are interested in the rate making impact of H.R. 229 on our citizens, and we clearly see H.R. 229 as an attempt to enjoin the major rate

reductions and refunds that we have won in the courts in the State of California and preserved in the federal courts. The refunds and rate reductions which the Cities have won are due and owing to all California customers of Pacific and General, not merely customers located in the Cities.

RATE ISSUES V. TAX ISSUES

We have reviewed the testimony of Mr. Hart and Mr. Dalenberg of the Telephone Companies. If one reads the testimony, one would think that the central issue of concern to the phone companies is a federal tax controversy. This is in error. What must be distinguished is a present rate controversy and a nonexistent, contrived tax controversy.

H.R. 229 is directed to a rate controversy. Pacific Telephone after losing in the State courts, the United States Supreme Court and the federal courts faces a rate liability for refunds in excess of $300,000,000. It is faced with the prospect of rate reductions of at least $80 million per year. General is liable for similar refunds and reductions commensurate with their lesser number of customers. By the most conservative estimates, each General and Pacific customer in California should receive a $40 refund and have rates reduced by $8 per year. We expect the refunds and reductions to be significantly higher.

For rate purposes, Pacific Telephone has taken the position that if it must make rate refunds, it will lose tax eligibility. It must be understood that Pacific Telephone has one position for rate purposes and one position for tax purposes. The telephone company's response to a rate commission's tax analysis and to an IRS tax analysis is far different. In some respects, the situation is analogous to a homeowner who when selling his home attempts to maximize the value of his home and gain the highest possible sales price. When he is faced with a property tax assessment, he attempts to minimize the value of his home.

For rate purposes, Pacific attempts to maximize its purported tax liability so it will maximize its rates and its profits. For tax purposes, Pacific attempts to minimize its tax liability and thereby maximize its profits.

An example of this dual method of presentation appears in Pacific's attempts in 1972 to avoid a refund. The facts in that case are similar to the refund obligation in the present case. The California Supreme Court ordered rate reductions and refunds in *City of Los Angeles* v. *Pacific Telephone*, 7 Cal.3d 331 (1972). Pacific asked the United States Supreme Court to stay the refunds and rate reductions. It told the United States Snpreme Court:

"Under the Court's order the Commission is required to reinstate the 1968 rates. These rates are on tbe basis of accelerated depreciation with flowthrough. In this situation the Internal Revenne Service undoubtedly will assert that under the Tax Reform Act of 1969 petitioner must compute and pay its Federal income taxes for this period on the basis of straight line depreciation. Thus petitioner can be required to pay millions of dollars in taxes, no part of which it will be able to recover in rates."

The United States Supreme Court denied Pacific's plea and Pacific was in fact required to make refunds and rate reductions. When its rate plea failed and the refunds were made, Pacific then for tax purposes (contrary to its rate representations to the Court) claimed that it was eligible to use accelerated depreciation. The IRS audited Pacific's taxes for the years 1970 to 1973 and affirmed that Pacific's eligibility was unimpaired. The threat of loss of eligibility was simply a cry of wolf to maximize rates.

In the instant case, Pacific found itself again faced with rate reductions and refunds. Pacific sought to retain the overcharges by claiming it would lose tax eligibility. Pacific retained a former commissioner of the Internal Revenue Service, Mortimer Caplin. For rate purposes, he asked for an IRS ruling declaring Pacific ineligible for accelerated depreciation and investment tax credit benefits. Mr. Caplan's letter to the IRS on behalf of Pacific dated September 29, 1977, stated:

"*Statement of position.*—Although Pacific obviously desires to retain the eligibility for accelerated depreciation, ADR, the class life system and the investment credit, it believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in good faith seek rulings that the Decision is consistent with those requirements."

For tax purposes when and if Pacific is ever challenged, Mr. Dalenberg has told the Commission that Pacific will then seek to retain eligibility. Pacific's Executive Vice President Latno told the press that Pacific would use the arguments the Commission and the Cities have adopted in an effort to retain eligibility in the event the IRS ever actually chalienges eligibility.

The claimed threat to tax eligibility addressed in the testimony to this Committee by Pacific and General is simply a tactic for the purpose of stopping an intrastate rate reduction and refund.

It must be further noted that if Pacific and General were concerned with the tax eligibility issue, they would be before Congress seeking a clarification in the tax law which would clearly confirm their eligibility. Instead, Pacific and General are here seeking a means to enjoin an intrastate rate order requiring refunds and rate reductions.

CONCLUSION

H.R. 229 is designed to enable Pacific Telephone and General Telephone to avoid refunds and rate reductions created by past overcharges. No justification exists for such legislation. The defects of the legislation will be further detailed in the testimony of Mr. Pines and Mr. Witt.

Mr. AGNOST. We represent the parties who so far are unknown to this committee; that is, the ratepayers of San Francisco, San Diego, Los Angeles, and the entire State of California. And we represent them as elected public officials. I am the elected city attorney of San Francisco; Burt Pines is the elected city attorney of Los Angeles, and John Witt is the elected city attorney for San Diego.

In our elected capacities, whe have brought action against the telephone company and, indeed, against the public utilities commission in the State of California to insure that the ratepayers of California were properly treated by the commission and by the company. As a result of our joint efforts, which involved going to the California Supreme Court twice, and going through the Federal system to the Supreme Court of the United States twice, and in every judicial instance we have prevailed on behalf of the ratepayers. To the extent that there is now owed approximately $400 million to those ratepayers by the company.

This company takes the position that if they pay these rates they will somehow suffer a tax liability. The fact of the matter is. H.R. 229 is their response in an attempt to reverse the judicial record over the last 10 years of what has occurred. In order to maximize the rate earning capacity before the commission, the telephone company has tried to take advantage of its tax liability. Coming before the commission they have tended to maximize their tax liability and, of course, coming before the IRS they ultimately, if not presently, would take a position to minimize that liability. Under normalization our California ratepayers have already paid the company for these taxes and the question of whether or not the companies are entitled to eligibility by making these payments is really something between them and the IRS.

We feel quite confident, as has happened in the past, they will be found to have retained eligibility. This specter of mass deficiencies is only an image and not the reality. Therefore, I ask this commission to have in mind that we should not try to change the equities of what has occurred. The equities have established that our ratepayers are entitled to a $400 million refund, and they are entitled to a rate reduction of $80 million a year. Also it should be noted that the real parties of interest in this matter are one, the telephone company, and two, the ratepayers of California.

The California Public Utilities Commission is not a real party in interest. They don't pay the taxes, and while they may use the phone system, they don't pay these rates. Our citizens pay these rates.

Because of our representation, we have so far secured for our citizenry a refund of $400 million. For the city alone we have secured close to $3 million in refunds. The question is about when shall it be paid.

This proposed legislation seeks to add another layer of obfuscation, if you will, to this whole process. The companies are seeking to set up a system of declaratory relief in which everybody but the real parties in interest litigate the matter. This is so, under this proposed legislation, the rate-payers, through their elected representatives are expressly precluded from coming in and insuring that the proper rates are maintained.

We are told that under this proposed legislation the rate can be set vis-a-vis establishing the tax liability or lack of it without participation by the ratepayers simply as a matter between the commission and the company.

I would say that——

Mr. MOORHEAD. Wouldn't it be easier, though, for the commission and for the cities and for everyone if some way could be found in advance to determine what the tax liability was, so that when the commission set the rates, they would know what they were dealing with? What the income was going to be and what the net proceeds were going to be? And they could make that determination in a fair manner for both the company and the citizens of California?

I think what we've got here is a situation where the commission doesn't know what the taxes are going to be, and the company doesn't know what their liability is going to be, and we are all fouled up. In some way or another there should be sense to this thing.

Mr. AGNOST. The point is, Congressman Moorhead, that it would be a fair system in the last analysis if it were necessary, providing the ratepayers could participate in that proceeding. The ratepayers, by this legislation, have been expressly precluded from participating. We as elected representatives, are precluded from coming into that declaratory relief action and setting the courts straight as to just where the equities lie. Have this in mind, it is the ratepayers that pay the taxes, not the company. The company collects the taxes from the ratepayers.

Mr. MOORHEAD. Perhaps they could come in as a friend of the court?

Mr. AGNOST. Hardly. The legislation says we shall not be allowed to participate. It is strictly between the commission on one side, which by the way is an administrative tribunal, and as such, it doesn't really have a justiciable interest. Whatever may be said for the matter, they are the Administrative Court. You have now proceeding before the tax court or the rate court for California and the telephone company. The rate court is really supposed to be the tribunal that makes the decisions as to rates. It, of course, should take into consideration what the tax liability is. But actually, that is not such an esoteric problem. Everybody in the United States has to consider what their tax liability is. This is true of every corporation, every private individual. And the fact of the matter is we are fairly successful at it.

Mr. DANIELSON. Proceed, sir.

Mr. AGNOST. For rate purposes, the telephone company has taken the position that it will lose tax eligibility. In 1972, this matter as essentially the same issue was presented to the California Supreme Court where reductions were ordered, and subsequently when the

company exhausted its judicial remedies, the IRS audited specific taxes for the years 1970 to 1973 and affirmed that it still retained eligibility.

So, in truth and in fact, the threat of loss of eligibility was really a matter of crying wolf and not a reality. In the instant case, the telephone company has secured the services of our former tax collector, Mr. Mortimer Caplin. Mr. Caplin sent a rather generally worded letter to the IRS asking whether or not they agreed that if the company made the refunds that it would lose its eligibility. That's like asking the tax assessor whether we should pay taxes.

The fact of the matter is that once these refunds are paid, the telephone company will be able to assert that it still has eligibility and the overwhelming probabilities are that they will retain eligibility.

Now, if there is any problem here, any problem of substance here, it is the threat of a deficiency assessment. That threat was created by the telephone company, and no one else. We had set up normalization procedures which had they been followed would have made even the possibility an impossibility.

Mr. DANIELSON. Sir, you have just stated an overwhelming to use your word, conclusion. Would you give me some facts which would lead to support that conclusion?

Mr. AGNOST. Well, the fact of the matter is that if the telephone company was really concerned about its lack of eligibility it should not be seeking to set up another layer of judicial review. It should be coming before this Commitee and other committees, if necessary, to assure legislatively that it will retain eligibility. And it really hasn't done so. This doesn't really address the problem which the telephone company says that they are concerned about the lack of eligibility. It doesn't address it at all. It just simply sets up another layer of judicial relief.

If I may address myself to that, in this day and age of inflation, we cannot close our eyes to the fact that the legal rate of interest on liquidated obligations is 7 percent, whereas the prime rate now that banks give their best customers is 12 and 13 and 14 and 15 percent.

Mr. DANIELSON. Twelve and three-quarters, as I read it last.

Mr. AGNOST. Twelve and three-quarters at a minimum, with the consequence that prolonging litigation, which has the effect of deferring payment of obligations that are liquidated, the company is making money. It is as simple as that. They are making the difference between 7 percent and 12¾ percent. That is a very substantial amount when you have in mind that we're talking here about $400 million in refunds, and obviously maybe some tax liability that they say may ensue.

So, they are saving money by simply prolonging the litigation and not addressing themselves to the problem. The problem is a very simple one: Are they going to lose tax eligibility? That is between them and the IRS, and the U.S. Government, and that can be solved very simply on, first, the administrative level and then if that is not sufficient, the legislative level without having to go to court.

Mr. DANIELSON. Incidentally, a recorded vote was noticed at 10:10. It is for the Committee of the Whole. Inasmuch as it is now 10:15, I recommend that we take a short recess, and I hope you gentlemen will return. We have to go to the floor.

[Brief recess.]

Mr. DANIELSON. Very well. We can continue.
Mr. Witt?
[Complete statement follows:]

SUMMARY OF THE STATEMENT OF JOHN W. WITT, CITY ATTORNEY OF THE CITY OF SAN DIEGO, REGARDING H.R. 229

The City of San Diego is opposed to H.R. 229 and the proposed AT&T amendments for the following reasons:

1. There is no need for additional jndicial review of state ratemaking orders.
2. Ratepayers or their representatives shouid be necessary parties in any declaratory judgment suit.
3. Ratepayers or their representatives should be allowed to seek declaratory reiief if public ntilities and ratemaking bodies are granted this opportunity.
4. The bill, as currently worded, could open the door of federal district courts to all types of artful pleadings.
5. The AT&T proposed amendments wouid limit the scope of the Johnson Act which has stood as a bulwark against federal judicial interference with state ratemaking proceedings for 45 years.

Mr. Chairman and members of the subcommittee, my name is John Witt and I am the City Attorney of the City of San Diego, California. I was elected City Attorney in 1969, and reelected in 1973 and 1977.

The City of San Diego appreciates the opportunity to make its views known on H.R. 229, a bill to amend Title 28, United States Code, to provide for a federal declaratory judgment in certain cases invoiving pubiic utiiities.

The City of San Diego, through its City Attorney, has participated in major utility rate cases, which affect its citizens, for many years. The purpose is to ensure that its citizens pay only just and reasonable rates.

San Diego is opposed to H.R. 229 and the proposed AT&T amendments for the following reasons:

1. More than adequate judiciai review is currentiy afforded public utiiities and there is no need for additional review.
2. The Biii limits the participation in a Deciaratory Judgment case to the public utility, the ratemaking body and the Secretary of the Treasury. No provision is made for participation by ratepayers or their representatives.
3. The pleading for a deciaratory judgment may oniy be filed by the public utility or by the ratemaking body. If, as has been the case in the California accelerated depreciation experience, the interested parties in a ratemaking case disagree with both the utiiity and the ratemaking body they would be foreciosed from seeking the reiief proposed by the Biii.
4. If the Biii is for the purpose of having a Federai District Court determine whether a ratemaking body's rate order destroys the eligibility of a public utility for accelerated depreciation and the use of investment tax credits it should so state. As presentiy worded § 2202(a) could open the federal door for aii types of artful pleadings. It is not inconceivable that the utiiities would aiiege in federai district court that various expense disaiiowances made by a ratemaking body were simply a subterfuge for "flowing throngh" the benefits of accelerated depreciation and the investment tax credit.
5. The AT&T Proposed Amendment 4 is an attempt to limit the scope of the Johnson Act (28 USC § 1342), which has stood as a buiwark against federal judiciai interference with state ratemaking proceedings for forty-five years. The Johnson Act begins with the words, "The district court shaii not enjoin, suspend, or restrain the operation of, or compiiance with, any order affecting rates chargeable hy a public utility. . . ." The Johnson Act has been instrumentai in protecting states' rights arising out of the Tenth Amendment of the Federal Constitution from federal judiciai intrusion. A utiiity currently has the right to federai review of a state ratemaking order by means of a petition for a writ of certiorari to the United States Supreme Court and this should remain the oniy federai remedy.

Pacific Teiephone and Generai Teiephone have proposed this Biii as a result of what has happened in California concerning the proper intrastate ratemaking treatment of federal tax expenses. A short history of the acceierated depreciation issue in California is necessary to determine what effect this Biii would have had if it were the law at the time the issue arose.

Since 1954 the federai government has permitted straight iine or accelerated depreciation in determining federal income tax iiability. All major California

utilities other than Pacific and General Telephone have adopted accelerated depreciation in computing and paying their federal income tax and the California Public Utilities Commission has required the utilites to pass on the tax savng to the consumer in the form of lower rates (flow-through).

Pacific and General Telephone, unlike the other utilities, refused to use accelerated depreciation in filing their income tax returns. On November 6, 1968 the CPUC concluded that Pacific's management was imprudent in not electing to take accelerated depreciation and held that for purposes of ratemaking Pacific would be treated as if it had obtained the tax saving of accelerated depreciation and that the saving would be flowed-through to the consumer in the form of lower rates (Decision No. 74917—69 CPUC 53). Notwithstanding this, Pacific continued to determine its federal tax liability using straight line depreciation.

In the Tax Reform Act of 1969 Congress amended § 167 of the Internal Revenue Code to provide that a utility could only switch to accelerated depreciation if it used a normalization method of accounting.

In 1970 Pacific filed a general rate case and by motion sought an order from the CPUC expressing the CPUC's intention to establish Pacific's cost of service for ratemaking purposes on the basis of accelerated depreciation with normalization. The motion was opposed by the Commission's staff, the Cities of San Diego, Los Angeles and San Francisco as well as others. Nevertheless the CPUC issued an order authorizing Pacific to use accelerated depreciation with the normalization method of accounting (Decision No. 77984–71 CPUC 590).

Under the proposed Bill it would appear that at this point in time (1970) no one could challenge the CPUC determination in the Federal District Court, but if the CPUC had denied Pacific's motion, then Pacific could have filed a pleading for declaratory relief.

The City and County of San Francisco petitioned the California Supreme Court for a writ of review of the CPUC's Decision No. 77984 and the writ was granted. The California Supreme Court then annulled the CPUC's decision (*City and County of San Francisco* v. *Public Utilities Comm.*, 6 Cal.3d 119 (1971)). The Court said:

> It thus seems clear the only reason it [Pacific] is not treated in this manner [accelerated depreciation and flow-through] is that in prior years it imprudently refused to file returns on a basis of accelerated depreciation and then after the 1968 decision obstinately continued in its imprudent refusal. Id. at 128.

The Court held:

> . . . the commission is not compelled to adopt one of the two extremes set forth above [flow-through v. normalization] but may adopt a compromise striking a proper balance between the interests of the ratepayers and Pacific in the light of current federal income tax statutes. Id. at 130.

It is not clear where we would be if H.R 229 had been the law at this point in time (1971). Could both the CPUC and Pacific seek declaratory relief in the federal district court? Could the federal district court enjoin the decision of the California Supreme Court? If so, are the parties that brought the successful action in the California Supreme Court precluded from the federal district court declaratory relief action? Has an actual controversy between a public utility and either the Secretary of the Treasury or a ratemaking body been created?

In 1972 the California Supreme Court annulled another CPUC decision which set rates based on accelerated depreciation with a normalization method of accounting: (*City of Los Angeles* v. *Public Utilities Comm.*, 7 Cal. 3d 331), and again in 1975 the California Supreme Court annulled the portion of a CPUC rate decision which set rates on a normalization basis (*City of Los Angeles* v. *Public Utilities Comm.*, 15 Cal. 3d 680), and remanded the case to the CPUC.

Again it is unclear what the effect would have been if H.R. 229 had been the law at this point in time (1975). § 2202(a) says:

> A court shall issue a declaratory judgment, as provided in section 2201, in a case of actual controversy between a public utility and either the Secretary of the Treasury or a ratemaking body, with respect to ratemaking or accounting provisions. . . .

It is submitted that there was no controversy between Pacific and either the Secretary of the Treasury or the CPUC. The controversy was between the Cities of San Diego, Los Angeles and San Francisco on the one hand and the CPUC and Pacific on the other.

It was not until the CPUC issued its Decision No. 87838 in 1977, in compliance with the remand order of the California Supreme Court, that a controversy be-

tween the ratemaking body and the public utility occurred. This controversy was taken to the California Supreme Court, the United States Supreme Court, the Federal District Court, the Ninth Circuit Court of Appeals, and back to the United States Supreme Court again. There is presently pending in the U.S. Supreme Court a petition for a writ of certiorari concerning Decision No. 87838.

It is respectfully submitted that more than adequate judicial review is afforded public utilities at the present time and there is no need for H.R. 229. The passage of H.R. 229 could seriously disrupt the delicate balance of federal/state relationships in regard to intrastate utility ratemaking. There are serious questions that would be raised if H.R. 229 is passed. These questions involve state's rights under the Tenth Amendment and the possible denial of due process if ratepayers or their representatives are excluded from the judicial process. In addition is the problem of what happens to the normal judicial review process. In the California accelerated depreciation experience there was no dispute between the public utilities and the matemaking body for many years—it was a dispute between the Cities and the CPUC as to the proper ratemaking treatment of Pacific's federal income tax. Not until the California Supreme Court ordered the ratemaking body to take certain action did a controversy between the public utility and the ratemaking body occur. Does H.R. 229 now propose that the years of litigation in the California Supreme Court and the United States Supreme Could l e vitiated by a federal district court?

Thank you for your attention.

Mr. WITT. Thank you, Mr. Chairman. My name is John W. Witt, and I am the city attorney for the city of San Diego. I was selected to that post in 1969 and reelected in 1973 and 1977.

I was first appointed deputy city attorney in 1961 and in the latter part of the 1960's participated as the city's representative before the California Public Utilities Commission when this dialog began, or at least in its very early stages. So, I have been around.

I would also mention to you, Mr. Chairman, that each of us has submitted to the committee a formal statement for the record and we are merely summarizing the statement really this morning.

Mr. DANIELSON. That is the procedure that this committee follows. And in case I have not already stated it, if there is no objection, the formal statements are received in their entirety and I hear no objection, so they are in.

Mr. WITT. Thank you very much. That is what I was aiming for.

The city of San Diego, through the city attorney's office, has participated in major utility rate cases for years and as I said, I have been personally involved in some of the litigation in ratemaking proceedings.

Mr. Agnost has explained in his prepared statement why the cities are involved in these cases. My prepared statement sets forth the various reasons that the cities are opposed to the passage of H.R. 229 and realizing the time constraints on the committee, I will not repeat those reasons here.

I do, however, think it is essential for the committee to understand why this bill is being proposed by the Bell System. It is not only for the purpose of determining specific eligibility to take advantage of accelerated depreciation and investment tax credits, it's also for the purpose of getting a new weapon to attempt to forestall refunds and rate reductions that have been ordered by the California Public Utilities Commission. If H.R. 229 had been the law during the long history of the litigation between the city on the one hand, and the California Public Utilities Commission and Pacific on the other, this would not have changed anything.

In 1970 the Bell System had convinced the California Public Utilities Commission that the only proper ratemaking treatment of acceler-

ated depreciation was the Bell System's accounting approach to normalization. The cities disagreed and took the issue to the California Supreme Court on three separate occasions, in 1971, 1972, and 1975.

The commission finally complied with the court's direction to come up with a ratemaking approach which did not force specific ratepayers to pay millions of dollars in phantom taxes, that is to pay rates which included an allowance for taxes which would never be paid by the utility, thus forcing the ratepayers to contribute interest free capital to the utility.

The commission issued this decision in 1977 and it rejected the Bell System normalization accounting and devised a normalization accounting system of its own. Up until the 1977 decision there had been no controversy between a ratemaking body and the utility, so the provisions of H.R. 229 would not have come into play.

Pacific appealed the 1977 decision through the State courts and to the U.S. Supreme Court. When it lost those appeals, it started all over again in Federal District Court, the Ninth Circuit Court of Appeals and back to the U.S. Supreme Court.

The petition for certiorari is apparently pending there. On August 13 of this year the U.S. Supreme Court dissolved the last stay that had been placed on the California Commission's 1977 decision and Pacific and General have now filed refund rate reduction plans. Pacific is proposing to make the refunds over a 5-year period, and that 5 years is somewhat significant in terms of the immediate impact on the company.

If H.R. 229 becomes law, there is not a shadow of doubt in anyone's mind at this table, I believe, that Pacific will be back in Federal Court in attempting to cancel any refunds that have not been made, and also in attempting to increase its rates. If the Bell System was sincere about its eligibility concerns, it would be petitioning Congress to change the wording of sections 46(f) and 167(l) of the Internal Revenue Code to insure that those sections do not impinge upon the intrastate ratemaking authority of the State, and to insure that utilities would remain eligible for accelerated appreciation and investment tax credits, regardless of what the ratemaking bodies did for intrastate ratemaking purposes.

Mr. DANIELSON. Let me interrupt at this point. You are not, of course, summarizing your statement, which is OK with me, but the point I am trying to make here you say is that they are not going to be the subject to this tax liability. How do you justify that statement?

Mr. WITT. I did not say that they weren't going to be liable for some tax liability. I said that their present plan is to—Oh, I am sorry. I haven't really addressed the question of their tax liability. What I was addressing was the question of the refunds to the ratepayers.

Mr. HUGHES. Will the gentlemen yield?

Mr. DANIELSON. Yes.

Mr. HUGHES. I gather the gentleman's point is indeed if the utility were sincere in their efforts to try to address the tax question, they would be in before the Congress trying to get Ways and Means or other committees to look at the specific provisions that apparently have to be interpreted.

Mr. WITT. Exactly. And as Mr. Pines pointed out just a moment ago to me we don't even know that they are ever going to have any tax liability.

Mr. HUGHES. If the gentleman would yield further?

Mr. DANIELSON. Surely.

Mr. HUGHES. Do you know of your own knowledge whether or not the utility has made an effort to get any of the committees in the Congress to look at that specific provision in the Internal Revenue Code 54 as amended?

Mr. WITT. Not since last time it was amended.

Mr. HUGHES. There's been no application?

Mr. WITT. Not that I'm aware of.

Mr. HUGHES. Thank you, Mr. Chairman.

Mr. DANIELSON. I believe you said not since the last time, but the sentence was not concluded.

Mr. WITT. The last time that 46(f) and 167 (l) and (m) were amended.

Mr. DANIELSON. You don't think there's been any since that time?

Mr. WITT. Not to my knowledge.

Mr. DANIELSON. You said you don't know that there will be a tax liability. Do you know that there will not be a tax liability?

Mr. WITT. Well, that I assume is up to the Internal Revenue Service in the future.

Mr. DANIELSON. That is the point that I hope you will keep in mind. As I understand the position of the utility, they are not sure that they will have a tax liability, but they are also not sure that they will not have a tax liability. Their liability, if any, under this law, because of accelerated depreciation and investment tax credit plus the impact of the flow-through order is one that puts them where they aren't sure whether they are going to have a tax liability or not, and therefore, whether they are going to be able to refund out of a tax saving or out of what, I don't know.

Mr. WITT. Well, all I can say to that is to my knowledge the company has never tried for a statement of eligibility before the IRS up to this point. We have no reason to believe that the IRS is not going to approve the system as previously approved by the California Public Utilities Commisison. With all due respect to you, Mr. Chairman, you described the Pacific Company as "the poor little guy in the middle."

Mr. DANIELSON. Well, I think you understood that to be a rhetorical comment. [Laughter.]

The record will be complete on this point because I immediately followed it up pointing that out whether you heard that or not.

Well, the record will speak for itself, and in case it doesn't, you now understand the position that it was rhetorical; correct?

Mr. WITT. Yes, sir.

The catch-22 the company finds itself in is one entirely, however, I would submit to you, of its own making. As the California Supreme Court has pointed out on several occasions, the Pacific Co.'s imprudent management decision to resist accelerated depreciation from the outset coupled at Mr. Halperin from the Treasury pointed out with A.T. & T.'s urging of the amendment to the Internal Revenue Code, which places them in the position they are now bitterly complaining about, seems to us to be a little interesting in respect to this catch-22 position that they are now in or they say they are in.

Mr. DANIELSON. I say they are in. Go ahead, proceed.

Mr. WITT. Well, they say it, too.

Mr. DANIELSON. So does the Internal Revenue Service say that. At least that is what Mr. Halperin's testimony here a little while ago was.

Do you know positively that they will or will not be exposed to a tax liability after this matter is finally resolved?

Mr. WITT. Assuming the Internal Revenue Service is going to address the question impartially.

Mr. DANIELSON. You may assume that. Go ahead.

Mr. WITT. I can't give you a positive answer until they have decided the issue.

Mr. DANIELSON. That's correct. That's the whole point. You can't give us a positive answer. Internal Revenue says they can't give us a positive answer. Maybe the telephone company is trying to pull something over on us here, but they say they can't give a positive answer.

I keep seeking for someone who can give us a positive answer, and that is the whole purpose of this bill—is to set up the courts as an instrumentality which will give a positive answer. Maybe we shouldn't do it. We will reach that conclusion much later, but what is sought here is some way to get a declaration of the rights and obligations of the parties without waiting interminably. That is the idea.

Mr. WITT. Well, Mr. Chairman, if the committee decides there is a need for a change in the declaratory judgment statute, we have drafted a suggested revision of the wording of section 2201(a) of H.R. 229, and if the committee is interested in receiving it, we will submit it at this time.

Mr. DANIELSON. Please do. Without objection, we could include it in the record at this point. Do you have a copy?

Mr. WITT. Yes, we have several.

[The complete statement follows.]

SUGGESTED REVISION TO THE WORDING OF SECTION 2202(a) OF H.R. 229 BY THE CITY OF SAN DIEGO

SECTION 2202(a) CERTAIN TAX CONTROVERSIES

(a) A federal district court may issue a declaratory judgment, as provided in section 2201, in a case of actual controversy with respect to the eligibility of a public utility to utilize the accounting provisions of section 46(f), 167(l) or 167(m) of the Internal Revenue Code of 1954. A pleading for a declaratory judgment may be filed only after a ratemaking body has issued an order, opinion or decision prodncing the actual controversy; however, in no event shall a pleading for a declaratory judgment be filed if the highest court of the State having jurisdiction over the ratemaking body has affirmed the order, opinion or decision of said body. Any party to the proceeding which resulted in the order, opinion or decision may file the pleading. In any such case the Secretary of the Treasury shall be joined as a party in the action; and any party to the proceeding which produced the controversy may intervene in the declaratory judgment action as a matter of right. In connection with any action brought under this section, the district court shall not enjoin, suspend or restrain the operation of, or compliance with, any order affecting rates chargeable by a public utility and made by a State administrative agency or a ratemaking body of a State political subdivision.

Mr. WITT. I would just summarize what is contained in it. First it leaves the discretion with the Federal district court as to whether it will issue a declaratory judgment or not; by changing "shall" to "may" in the first sentence of the legislation.

It insures there will be no Federal-State conflict between a decision of the highest court of a State and a Federal district court. It allows

ratepayers or their representatives to seek declaratory relief. It allows ratepayers to intervene as a matter of right in any Federal declaratory judgment action and prohibits the Federal district court from enjoining, suspending, or restraining a State ratemaking order—in other words insuring that the Johnson Act, section 1342 of title 28 of the United States Code, is not abrogated.

Mr. DANIELSON. Is that substantially the same as the resolution which was adopted a few weeks ago by the Association of Regulatory Agencies, the resolution that has been offered by former Senator Sturgeon of California?

Mr. SNAIDER. I believe there is one difference. I believe the NARUC resolution encompassed all Federal tax questions, rather than just the accelerated depreciation and investment tax credit. What we have done here is limited our assumptions to investment tax credit and accelerated depreciation, and assuming you want declaratory relief, we have put in what other conditions they had——

Mr. DANIELSON. Would you spell that acronym for the reporter?

Mr. SNAIDER. Yes. Capital N-A-R-U-C.

Mr. DANIELSON. Thank you. Very well. Proceed, please, with your statement.

Mr. WITT. I'm finished, and Mr. Pines will proceed.

[The complete statement follows:]

STATEMENT OF BURT PINES, CITY ATTORNEY, LOS ANGELES, CALIF., ON H.R. 229

SUMMARY OF STATEMENT

The Los Angeles City Attorney's Office has a strong interest and a long history of representing the City and its citizens ratepayers in major utility matters. H.R. 229 is objectionable because it does not grant the ratepayers and their representatives eqnal access and participation in the federal proceedings.

H.R. 229 represents a further effort by the telephone companies to avoid the implementation of California Pnblic Utilities Commission Decision 87838. PUC Decision 87838 orders refunds approximating $400 million in overcharges. This has been estimated to be approximately $30 to $40 per ratepayer.

H.R. 229 is nnnecessary. The telephone companies already have adequate remedies to resolve the eligibility issues in the federal courts.

As a result of its broad language, H.R. 229 would encourage intervention by the federal courts in intrastate ratemaking. This is contrary to the longstanding federal policy represented by the Johnson Act.

Under H.R. 229 it is likely that a federal court will issue an injunction pnrsuant to its equitable power and thereby interrupt intrastate ratemaking, contrary to the federal policy underlying the Johnson Act.

While declaratory relief has been allowed for resolving some tax issues, the policy reasons warranting such exceptions are absent in the case at hand.

Mr. Chairman and Committee Members, thank you for the opportunity to address this Snbcommittee. I am the City Attorney of Los Angeles. I was first elected City Attorney in 1973 and re-elected in 1977. Prior to my election as City Attorney, I served as an Assistant United States Attorney and also practiced law in the private sector.

ROLE OF THE CITY ATTORNEY IN RATEMAKING PROCEEDINGS

My appearance here today is consistent with the historical role of the City Attorney's Office in ratemaking proceedings in the State of California. Our office has actively represented the City and its citizens in ratemaking proceedings for at least the last 20 years. It has been our policy to intervene in all major telephone and gas ratemaking cases before the Public Utilities Commission ("PUC"), usually joining with the Cities of San Diego and San Francisco.

The City of Los Angeles itself is a large consumer of utility services and has a strong interest in all ratemaking proceedings affecting it. Its combined telephone

bill for Pacific Telephone and General Telephone services exceeds $4 million annually. The average citizen also has an interest, but has neither the resources nor expertise for effective representation before the PUC. Our office assumes the role of advocating the interests of ratepayers.

Our participation, and at times opposition to the utilities has been instrumental in the decision-making process. Furthermore, when the PUC has ruled incorrectly, appeals by our office and the Cities of San Francisco and San Diego have been necessary to remedy the error.

As a participant in rate cases, Los Angeles has the right to appeal an unfavorable Commission decision directly to the California Supreme Court. Such appeals are necessary to balance the rights of the ratepayer with that of the utilities.

H.R. 229, as presently drafted, does not provide for equal access and participation by the Cities and other interested parties in the federal proceedings. This is a significant defect of the bill, which could deny representation to the ratepayers, even though they are parties to a related PUC case.

HISTORY OF THE INSTANT RATE CASE—DECISION 87838

It would be useful to this Subcommittee to be aware of the history of the California ratemaking case, which spawned the telephone companies' efforts to amend 28 USC 2201. That case concerns the proper ratemaking treatment of the benefits of accelerated depreciation and investment tax credits. In this respect, "normalization" accounting is the ratemaking methodology which provides all of the benefits to the utilities. "Flow-through" accounting is the methodology which provides all the benefits to the ratepayer.

After the passage of the 1954 Internal Revenue Act, the PUC adopted "flow-through" accounting for all utilities that elected to use accelerated depreciation. All major utilities in California, with the exception of Pacific and General Telephone, adopted accelerated depreciation with "flow-through." Pacific and General (hereinafter "telephone companies") refused to take advantage of the tax savings resulting from accelerated depreciation and investment credits, and elected to pay higher taxes.

In 1968, the PUC decided that telephone rates should be set on the premise that the telephone companies had adopted accelerated depreciation with "flow-through" and had utilized the investment tax credits. The rationale was that management was "imprudent" for failing to use these benefits (as all other major utilities did), causing the ratepayers to pay higher taxes. The telephone companies did not appeal the PUC's order to the California Supreme Court. Instead, they successfully lobbied for a change in the income tax law. Internal Revenue Code Sections 46(f), 167(l) and 167(m) (the subject of H.R. 229) were the result. The discussion below refers to Section 167(l), but the basic arguments can also be applied to Sections 46(f) and 167(m).

Under the telephone companies' interpretation of Section 167(l), utilities that previously elected to use accelerated depreciation with "flow-through" could remain on "flow-through" without losing the tax benefits. However, if a utility such as the telephone companies had not previously elected accelerated depreciation, it could only obtain the tax benefits of accelerated depreciation if it was permitted by the PUC to use "normalization" accounting for ratemaking purposes.

The telephone companies subsequently persuaded the PUC to permit them to use accelerated depreciation with "normalization" (that is, the telephone companies' version of "normalization") on the basis that current tax law precluded the PUC from adopting accelerated depreciation with "flow-through." The Cities appealed to the California Supreme Court, and in 1971 the decision was overturned and remanded back to the PUC. Two additional attempts by the telephone companies and the PUC to implement accelerated depreciation with the telephone companies' normalizaion methodology were struck down by the California Supreme Court in 1972 and 1975, respectively, again as a result of the Cities' appeals.

In 1977, the PUC, in Decision 87838, adopted a "normalization" methodology which was upheld by the California Supreme Court in 1978. In this last proceeding, the telephone companies were the appellants and the Cities defended the action of the PUC. After losing, telephone companies unsuccessfully appealed to the United States Supreme Court.

The companies then decided to seek unprecedented injunctive and declaratory relief in the federal courts. They lost in their attempts in the District Court and in the Ninth Circuit Court of Appeals. On August 3, 1979, Justice Rehnquist denied their request for a further stay of the decision. Currently, the issue is before the United States Supreme Court by way of a writ of certiorari. It is

anticipated that the Supreme Court will soon rule on the writ, and we are optimistic that the writ will be denied.

I believe this historical review is necessary in order to put H.R. 229 in its proper perspective. As evident, Pacific and General have spent over a decade attempting to secure accelerated depreciation with telephone company "normalization." Now that the litigation is virtually complete, the companies, by way of H.R. 229, are making a last ditch effort to obtain remedial legislation which could further delay implementation of the PUC decision. At stake is approximately $400,000,000 in overcharges and interest due California telephone users plus prospective reductions approximating $80,000,000 annually. It is estimated that the average telephone user will receive between $30 and $40 for past overcharges. The prospective rate reduction approximates 75 cents per telephone user per month.

The telephone companies have filed two refund plans with the PUC. One plan asks the PUC to amortize the refunds over a five-year period. In the event such a plan were adopted, and H.R. 229 enacted, it is likely the telephone companies will seek another declaratory judgment and request an injunction to stay the PUC decision pending resolution of the federal action. Our concern is that in the absence of a specific prohibition against injunctive relief, a federal court could issue an injunction under its equtable powers and further delay the refund to consumers.

ADDITIONAL OBJECTIONS

We believe that H.R. 229 is unnecessary. The tax problem is unique to the two telephone companies in California. The energy utilities in our State have all elected accelerated depreciation with "flow-through" and are not in need of this legislation. Those remaining California utilities with requests respecting investment tax credits have recently received favorable IRS rulings.

After 10 years, the current ratemaking controversy between the Commission, the telephone companies and the three Cities is about to conclude. The telephone companies have ready access to the federal courts through existing procedures to resolve any eligibility issues. If the IRS denies eligibility and issues a notice of deficiency, the companies may file an appeal in the Tax Court or bring a refund suit in the District Court.

Another problem with H.R. 229 is that it allows declaratory relief "with respect to the ratemaking or accounting provisions" of the sections designated. Such a law would open a "Pandora's Box" and encourage a vast amount of litigation and federal intervention in state ratemaking issues. The Johnson Act, 28 U.S.C. 1342, was enacted to preclude that type of federal court activity. This well established policy should not be overturned.

H.R. 229 is also inappropriate because the policy reasons warranting an exception to the rule against declaratory judgments in tax cases are lacking in the present circumstances. Where declaratory relief has been permitted, for example, in claims for exemptions for charitable organizations and municipal bonds, there was no judicial review otherwise possible from an adverse IRS ruling. By contrast, the telephone companies do have a judicial remedy in the federal courts from an unfavorable IRS ruling.

If the telephone companies had adopted accelerated depreciation with "flow-through" as all other utilities did after the enactment of the 1954 Internal Revenue Act, we would not have this problem today. Moreover, if the eligibility question does materialize, it will be resolved by the federal courts and we will not have this problem in the future. Therefore, we respectfully urge that your Subcommittee reject this unnecessary and undesirable legislation. Thank you.

Mr. PINES. Thank you, Mr. Chairman. My statement is in the record. My purpose here is to summarize the objections that we have to this measure and, as much as possible, to try to respond to some of the very good questions that you and Congressman Moorhead and Congressman Hughes have raised so far, that I think, are really focusing the attention of the committee.

Very briefly, though, by way of a broad perspective on this measure, we are here today, as you know, because we are concerned about the $400 million in refunds that have been labeled overcharges now due our California constituents. That is between $30 and $40 per household. It means $8 to $9 reductions—about $80 million in the future.

That is what is at stake, and we are, of course, here because we feel this is a last-ditch effort by the telephone company to try to avoid those refunds, hoping that this will go through, hoping that a Federal court pursuant to its inherent powers will issue an injunction and stay the proceedings, and that some way or another that could effect these refunds in the future.

And as you know, this issue has been going on now for the last decade in the State of California, and it has been the cities who time after time have had to take the phone company and the PUC, under a prior PUC, to the California Supreme Court.

But to reach the result that we now have in the State of California, I know that is something that everyone on the committee is concerned about, and yet I also realize your concerns that there be some kind of answer to what appears to have been a real problem that the phone company has. There are objections to the bill, some of which you are aware of.

One is that it fails to provide the kind of equal access to the courts that, on the part of the ratepayers and their representatives—it has been the cities on behalf of the ratepayers that have kept this issue alive. And if this bill had been in effect 5 years ago, let's say, when there was no issue between the phone company, the IRS, and the PUC, everyone was assuming eligibility would be lost—that there was no way this could have gone into the Federal courts, or if it did go in, it would have been a very friendly lawsuit. It would have been essential at that time for the cities and the ratepayers to have been a party and to think that the matter simply could have been removed next door to the Federal court, so to speak.

Mr. DANIELSON. You're saying there was no controversy?

Mr. PINES. It was the cities that put the matter into controversy. It was the cities that said we don't think the phone companies are going to lose eligibility; you should not assume that. And it is the cities that took that view all the way to the supreme court and got the supreme court to agree with us on that issue for ratemaking purposes.

Mr. DANIELSON. Let me interject.

Mr. PINES. It would have been important for the cities to be involved all the way along.

Mr. DANIELSON. Let me interject a question, and I appreciate your summarizing. And I trust you're not done, because you have other points here, but what you are saying in essence is that 5 or 6 years ago, the public utilities commission and the telephone company, and insofar as we knew at that time, the Internal Revenue Service had no controversy. Therefore, there would have been no basis for declaratory judgment.

Mr. PINES. That's correct. The PUC went along with the phone company and assumed there would be a loss of eligibility and did not pass the benefits on.

Mr. DANIELSON. And it was not until the California Supreme Court interpreted the Internal Revenue Code to mean, in effect, that there would not be a loss of eligibility for the tax benefits, that the controversy arose.

Mr. PINES. That is correct.

Mr. DANIELSON. When did that first take place?

Mr. PINES. The cities brought that to the California Supreme Court.

Mr. DANIELSON. When did that judgment first come down?

Mr. PINES. It was in the midseventies.

Mr. SNAIDER. The very first judgment was in 1971, and the California Supreme Court said that even if they lost eligibility, it didn't impede ratemaking options open to the commission. But the first and really the most definitive discussion is in the 1971 case. There wsa a 1972 case and a 1975 case where there were full written unanimous opinions of the California Supreme Court.

Mr. DANIELSON. But it is the 1975 judgment that is controlling, and what it amounts to is that the California Supreme Court has said that the telephone company will not lose its eligibility. Is that correct?

Mr. PINES. No; it did not reach that ultimate issue. But by the same token, it criticized the PUC for assuming that issue and felt that there would be a way that the benefits could be passed on to the consumer.

Mr. DANIELSON. The PUC position was then that they would lose their eligibility?

Mr. PINES. Yes.

Mr. DANIELSON. And the Supreme Court says you've gone too far. You cannot conclude that they will lose their eligibility?

Mr. PINES. Yes. And the matter was remanded to the PUC. And it is because of that remand—again, that was because the cities brought it there—that we have the order today.

Mr. DANIELSON. I'm going to give the cities credit for everything, so you don't have to repeat that.

Mr. PINES. Well, I say that to make the point that is essential that the cities be a party to these matters. Congressman, that is the reason I'm saying; not to slap myself on the back.

Mr. DANIELSON. I'm thinking of a different thing. I'm thinking how can the telephone company be sure today or tomorrow that it will not lose its eligibility for the tax benefits, if the reduction realized by the benefit is passed through to the consumer?

Mr. PINES. Let me respond to that, which leads to the next point. And I know this is something you've been getting at.

For one thing, the telephone company does have remedies. It has the normal remedies available to any taxpayer an appeal to the Tax Court, if there is a notice of deficiency—and by the way, that would come up soon, because their 1974 audit is about done of, of course, the refund action in the district court. Those are remedies available, and they can get that determination.

Mr. DANIELSON. In the foreseeable future?

Mr. PINES. Yes; they could get it in the conceivable future. Furthermore, I would submit to you that those kinds of remedies provide the strongest test of the issue.

Our concern would be that if you had the declaratory judgment in effect, all the motivation on the part of the phone company in the past was to take the view that they would lose eligibility because that allows them, of course, to avoid any rate refunds to the consumers, to avoid passing on these benefits to the consumers, to keep all of this capital but, by the same token, allows them to take full advantage of the tax laws that have allowed for the accumulation of this capital.

Mr. DANIELSON. But wait a minute, did not the tax law, assuming now that they would not pass it through which was one of your hy-

potheses a moment ago—assuming that, would not the phone company be required to utilize the savings for capital investment?

Mr. PINES. They, of course, were doing that. There is no dispute on that.

Mr. DANIELSON. So they weren't putting it in the locker some place?

Mr. PINES. No.

Mr. DANIELSON. They weren't keeping it in the sense of buying treasury notes or something like that. They would have to spend it. The tax law requires that they spend it for capital investment.

Mr. PINES. It was utilized for capital investment, but the PUC has taken the view that some of the benefits ought to be passed on to the ratepayers. And I might mention that only approximately 25 percent of those benefits are being passed on—not 100 percent. They are still keeping 75 percent of those tax benefits for capital purposes.

But you have to keep in mind that most of the utilities in California flow those benefits through and that in ratemaking, it is felt properly that a lot of these benefits should flow through to the consumer. There's nothing wrong with that, even though the tax laws allow the companies to accumulate this capital.

Mr. DANIELSON. Is it your position that the cities take the position that the Internal Revenue Code should be so construed that the utility may have the option of flowing it through or utilizing it, and in either instance, it has derived the tax benefit. Is that correct?

Mr. PINES. Yes; and that ties in with the question Congressmen Hughes and Moorhead both mentioned, that if the company wanted a direct answer and a definitive ruling on this, it is not through declaratory relief. You don't know how a Federal court is going to rule. We can't say one way or the other right now what they're going to do.

If you want that relief, you amend the Internal Revenue Code to protect their eligibility in this kind of a situation, and then it is done with.

Mr. DANIELSON. I smile slightly, because you probably don't realize how difficult that is. I'm not sure but what declaratory relief is infinitely faster. [Laughter.]

Mr. PINES. You are more of an expert on that process than I am. But, again, why isn't the phone company asking for that?

I think the answer is simple, because if they got that ruling, there would be no question they would have to make these refunds to the ratepayers of California. They wouldn't have the excuse that they would lose eligibility and would have to make these refunds.

What they are trying to do here, of course, is have their cake and eat it too. They want all of the benefits of the tax laws to accumulate as capital, but they don't want to pass it on to the ratepayers through this PUC order.

Mr. DANIELSON. Well, I always assume that to be true. Isn't that human nature?

But let me ask you—this is pertinent. You talk about this $400 million in refunds. Can you tell me whether—I want the record to reflect—has all or any part of that been made?

Mr. PINES. No.

Mr. DANIELSON. No part of it?

Mr. PINES. No; there are payment plans now before the PUC.

Mr. DANIELSON. But no part has been paid?

Mr. PINES. No; but it should be paid before the end of this year.

Mr. DANIELSON. Now when those payments are made, if they are made, do they cary with them interest?

Mr. PINES. Yes.

Mr. DANIELSON. At what rate?

Mr. PINES. Seven percent. Of course, there is an economic incentive for delaying this when you think of the cost of borrowing capital.

Mr. DANIELSON. I'm aware of that, you may remember, and it is still true, even in California, that one of the ways insurance companies make their money is to set up a reserve every time there is an accident and then sit on it for the period of limitation before they pay out, because they have collected all of that good, juicy interest for 3 or 4 or 5 years. And then when they pay out, they have had the benefit of free captial. That is why the insurance companies own Wilshire Boulevard. [Laughter.]

But we can't cure that here today. Go ahead. You are doing us a lot of good.

Mr. PINES. Congressman, I was making the point that the present remedies are the best remedies, because it really forces the Pacific Telephone into an adversary position with the IRS at this point because they know they're going to have to pay those refunds, where in the past all of their incentive were to get a ruling from the IRS that they would lose eligibility.

And the declaratory relief action could very much have been a friendly lawsuit, where they are trying to get the very ruling that they finally have gotten. As evidence of that, of course, is their request to the IRS—and I might mention they have gotten a ruling from the IRS, a preliminary ruling, that they would lose eligibility.

But when you look at the way that was raised, Mr. Caplin's letter which is in the San Francisco statement states that the phone company cannot, in good faith, seek a ruling from the IRS that they are going to be able to maintain eligibility. I mean, the whole way the issue was presented to the IRS was to obtain what they wanted—was a favorable or unfavorable ruling, depending on how you look at it, but basically the ruling that they would lose eligibility, and that same thing could happen in the declaratory relief posture.

The better, of course, and the best way to test the issue is through the normal appellate procedures allowed in tax cases which they still have. And even if the PUC is proved to be wrong, even if there is a loss of eligibility, let's assume that the worst happens——

Mr. DANIELSON. I was just going to ask you, now, hypothecate that the ultimate ruling is that they lose eligibility. Now what's going to happen?

Mr. PINES. Let's look at that first. First of all, the phone company does have reserves set aside. Second, any kind of a deficiency can be paid over a period of time. And most importantly, the PUC is going to make adjustments in their future rates, giving them rate increases to make up for this. And that is going to happen in the future. We can assume the PUC is going to act responsibly, and that is the way it should occur. As costs go up, expenses go up. That can be accounted for in the ratemaking process.

Mr. DANIELSON. Suppose, again, hypothetically here, suppose that the refunds are paid in toto. Suppose that thereafter the Internal

Revenue Service, the Supreme Court—there is an ultimate decision that they have lost their eligibility, so therefore they have paid these refunds out of thin air, in other words, how can they recoup that money?

Mr. PINES. They can recoup it from future rate increases.

Mr. DANIELSON. The PUC—may it give a future rate increase to cover, in effect—what in effect was a retroactive loss?

Mr. PINES. It will provide a rate increase to cover present costs.

Mr. DANIELSON. Present costs will be paying the old bills, in other words?

Mr. PINES. Yes.

Mr. DANIELSON. I'm sorry to interrupt. Please continue, but these questions come up now and again.

Mr. PINES. That would be the theory. We have someone from the PUC who can address that even further. But the idea is that the PUC wants to insure that the phone company, as any utility, is receiving a fair rate of return. And it can look at the companies' financial picture is at that time and provide relief by way of an upward rate adjustment if that becomes necessary.

Again, that is only if a final Federal court tells them that they've lost eligibility.

Mr. DANIELSON. Well, that was the hypothesis.

Mr. PINES. We think the best way for that issue to be tested is through the remedies they have now which can be pursued very quickly.

Our other concern is that with this bill in place, it just opens the door for Federal injunctions, Federal interference in State ratemaking cases, all of which is contrary to the longstanding policies that the Federal Government has had by way of the Johnson Act. That is a major policy change which ought to be avoided if it is unnecessary.

Furthermore, we think that declaratory relief is not an appropriate remedy in this kind of a matter. You know, you can easily see the benefits of declaratory relief when you want to interpret a statute. There it is—the four corners. You don't need much in the way of a record. It is fairly clear and easy to deal with.

The ratemaking process is a fluid one. It can constantly change. There are all kinds of commutations and permutations between total flow through or total normalization, and if you change any one of these facts, that may influence the Federal court. And you can have a situation where every moment people are going back into the Federal court to see if this fact makes a change, and the process never ends. You can eventually come out with a final PUC order that is different from the facts earlier presented by way of the declaratory relief process, and now you have a second case. So you are just encouraging excessive litigation in a very difficult area where it is hard to define what will come within the tax laws and what will go beyond the tax laws. And that is unique in ratemaking cases.

And I don't think it is wise to expand declaratory relief into this kind of an area, if it can be avoided, if there are other solutions. And I have tried to point those out.

I further would submit that this problem has by and large been unique to California. I can't say it isn't going to happen elsewhere, but we can say it is going to happen elsewhere. And without that kind

of national concern, this kind of drastic change in the tax laws do not seem warranted.

We ought to have much more experience under our belt to warrant expanding the tax laws, or rather the Federal procedures, this much. And I think it is premature at this point to do so.

Mr. DANIELSON. I might comment on that last position of yours. Normally, when we are considering a change in remedies available through the Federal courts, we hear from the Administrative Office of the Courts for the Judicial Conference rather promptly as to whether this is going to increase their workload. And I am not saying we will not hear from them on this matter, but as of this morning they have been silent. So I don't think they contemplate a massive increase in workload.

Mr. PINES. I guess the final point, I think, that has to be balanced here—we talk about the equities—is the point that City Attorney Witt made, and that is to a great extent the phone companies have put themselves in this position. Other utilities are currently flowing through the benefits of accelerated depreciation. These other utilities elected accelerated depreciation prior to 1969.

Despite that, the phone company insisted on utilizing straightline depreciation. They were criticized as being imprudent by the California Utilities Commission, and that precipitated a change in the tax laws in the late 1960's.

And this is a situation by and large created because of their actions, and one that they can live with and one that can be resolved through normal judicial processes now. And at worst, if it cannot be, the solution should be a change in the tax laws, rather than expanding the procedural laws, because the change in the tax laws will give the answer. We can't say that the procedural changes opening the declaratory relief judgment to this kind of a situation would necessarily give them eligibility.

So those are the points I wanted to make. I have tried to respond to areas of your concern, Congressman. But we are all available for questions.

Now, we have some excellent staff people here who are much more on top of this.

Mr. DANIELSON. I'm pushing a little bit because time is beginning to run out.

Mr. Hughes?

Mr. HUGHES. Thank you, Mr. Chairman.

There are just two questions, two areas I'm interested in. You mentioned that the utility has set up a reserve. Do you know the extent of the reserves?

Mr. PINES. We can provide that. It was alluded to in Mr. Dalenberg's testimony from the telephone company last time, and he is here today and can comment further on that. But there have been reserves established.

Mr. SNAIDER. It is a reserve on paper. I want to make that clear. It is on their books. But the reserve for the accelerated depreciation is total. Every back tax liability that might accrue on the accelerated depreciation is included in that reserve.

Mr. AGNOST. In addition, Mr. Congressman, the company has represented to the California Supreme Court that it is fully capable of making the refunds and it has the funds for that purpose.

Mr. HUGHES. You indicated that you felt that any procedure under existing remedies in the Tax Court, either by way of refund or what have you, could be handled expeditiously. Is it your judgment that it could be handled as expeditiously as a proceeding through declaratory judgment relief?

Mr. PINES. It is our judgment that it could be. The letter from the Treasury Department confirmed that. They indicated that the audit on one of the years—I think it was 1974—is about done. If there is a notice of deficiency, an appeal could be made very quickly to the Tax Court. It is not a matter of having to wait until 1983 at all. And the liability, of course, which was projected by the phone company was projected all the way through 1983, when they got into the billions. If you ended it in 1979, it is much less than that.

Mr. HUGHES. I do have one additional question, Mr. Chairman. With regard to the question that has to be resolved in determining eligibility and interpreting the Internal Revenue Code of 1954, what is it specifically in the language of the Internal Revenue Code which is the subject of interpretation, which will in the final analysis determine whether or not their accounting system——

Mr. SNAIDER. I know you are asking for an extremely specific citation. I can give it to you generally, if that would be satisfactory, or we can answer you with chapter and verse in writing, if that would be preferable.

Mr. HUGHES. A general statement of the area in question is sufficient, because it has been suggested—and I think it's a very important point—that if indeed the utility were sincere in its efforts, it would be before the Congress and trying to clarify the provisions of the Internal Revenue Code of 1954.

Mr. SNAIDER. Let me explain what the real conflict is involving eligibility. Mr. Dalenberg in his statement to you cited three conditions under which you must meet to maintain normalization. I believe that was at page 6 of his statement. And I will hope to cite that to you.

The key point is that the first two points that Mr. Dalenberg made—this was his statement to you of August 2—the first two points of his statement are in the statute and there's no problem with complying with those first two points.

The third point of his statement—and I will read this to you and then I will explain it. It may get slightly technical—it is—this appears on page 5 of his original statement, the third point, and we'll read this to you:

> The regulatory agency may not exclude from rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service.

That one sentence is what the phone companies say the utilities commission violated. That one sentence does not appear in the act anywhere. The congressional history said that, as to the exclusion from rate base, and the congressional history is very clear—we cited this to the Supreme Court—Congress left the exclusion to rate base to the discretion of the public utilities. That is not in the act. It is in the statements of congressional intent, both House and Senate.

So this third point which causes the ineligibility, upon which ineligibility is based, is not even in the act. And that is where the dispute is. As a matter of fact, agencies of the United States have appeared

before the California commission—and this is GSA—represents Federal agencies before the California commission, and they were joined by the Department of Defense, specifically said that the act as written could not permit ineligibility for violating this so-called exclusion from rate base, because exclusion from rate base was not part of the act and the intent did not encompass that.

But that is why ineligibility is claimed, because violation of that third point of Mr. Dalenberg's, which you will not find written in the tax law.

I hope that was responsive.

Mr. HUGHES. Your testimony is that the utility has not as yet, to your knowledge, sought any clarification from Congress of our intent when that particular section was adopted by the Congress?

Mr. SNAIDER. Absolutely. The only thing they sought was a request by Mr. Caplin where they requested to be held ineligible. They requested that to the IRS. They have not come to Congress to clarify this silent prohibition which they now claim, that is correct.

Mr. HUGHES. Have you looked at the specific request that perhaps the utility would have to make to the Congress to clarify that? Have your legal staffs made a determination as to what could be sought from the Congress to clarify the provisions of the Internal Revenue Code to make certain that the exclusion to which you make reference was not intended to deny eligibility?

Mr. SNAIDER. We haven't drafted it. In essence, we think all that would be necessary in the act was to codify the congressional intent stated in both the House and Senate reports, which congressional intent was that this was in no way meant to interfere with the treatment of rate base and normalization reserve which appears in both the House and Senate reports.

Mr. HUGHES. Mr. Chairman, since we have the city attorneys from three major cities in California present, who obviously have worked very diligently on this matter, I wonder if we could invite them to submit to the committee their suggestion as to how the Internal Revenue Code at this point could be clarified in specific language that would carry out the intent?

Mr. DANIELSON. Yes, there is no reason at all. In fact, gentlemen, you are invited. And I hope you will accept the invitation very promptly, because we do want to move along with this.

Mr. HUGHES. Mr. Perez, you wanted to comment?

Mr. PEREZ. Yes, Mr. Hughes, if I might expand just a little bit, we do feel that responsibility for that clarification effort lies with the telephone companies. However, we are more than willing to work to clarify that issue, because eligbility is important to the telephone companies as well as the ratepayers of California.

In fact, we intend to join in their efforts once the issue reaches the tax courts, and we intend to continue to present substantial evidence and arguments to show that they should be eligible. We are going to join them in that effort and we would be glad to join them in efforts as far as the Congress is concerned.

Mr. HUGHES. Well, I thank you. I think it is important, because in essence what we are being requested to do is to set up a new procedure that will enable the courts to interpret what was congressional intent. And it would seem to me that if there is some confusion as to con-

gressional intent, that the best way to address that perhaps would be through a modification, if need be, of the Internal Revenue Code, or a clarification, if there is some question about that. And that is the point that I think you've made, and I think it is a good point. And so I would welcome any suggestions you have as to how the Internal Revenue Code could be clarified, because if indeed eligibility is denied, then at that stage we are going to be faced with that ultimate issue anyway. So if we're going to be faced with that issue, perhaps we ought to face it now, and perhaps not obliquely through some mechanism to try to secure a declaratory judgment, which is the approach that has been taken.

Mr. PINES. Mr. Chairman, I was going to make the comment that we are pleased to present that to you, and we have this ironic situation where I get the sense that the cities, on behalf of the ratepayers, are much more interested in preserving the phone company's eligibility than the phone company. And so we find ourselves in this awkward position, almost, of having to be advocates on their behalf. And we will want to enter this tax case to make sure that the issues are really framed.

We're going to be fighting to preserve their eligibility where it might be in their interest to avoid it, to lose it, because they will thereupon avoid having to make these refunds or flowthrough the benefits to the ratepayers. That seems unusual in tax proceedings, for third parties to be more interested in preserving a taxpayer's tax benefits for eligibility than the taxpayer themselves. And that's where we are at.

Mr. HUGHES. Well, I can assure you, we see a lot stranger things around here than that. [Laughter.]

But I want to thank you, because obviously you have done a good job on behalf of the people of California.

Mr. DANIELSON. Mr. Mazzoli of Kentucky?

Mr. MAZZOLI. Thank you very much, Mr. Chairman.

I'm not sure I can follow all of the esoterica here about the tax law. But I get the impression that the telephone company has to be dragged, kicking and screaming into this situation where they are entitled to certain tax relief. And you ar apparently offering to be the pushers and the dragger. Is that the idea?

Mr. PINES. That is correct.

Mr. MAZZOLI. Let me ask one thing. If you were to pursue this, in a sense encouraging the telephone company to obtain relief by whatever means, your position does not change with regard to the $400 million, and with regard to the entitlement of the people of California to have this money refunded to them?

Mr. PINES. No, it does not.

Mr. MAZZOLI. I think that is good that you feel that way in your representational capacity for your people, you feel that they are entitled to have a telephone company which has qualified.

Again, this is a very complicated matter and I would hope that everybody understands you are not diminishing your strength of argument on behalf of this return of money and your opposition to this bill and to the declaratory relief; is that correct?

Mr. PINES. Not at all. The two purposes are entirely consistent.

Mr. MAZZOLI. Well, they are different, but there is this irony here, where on the one hand you are arguing against them, and then on the other hand you are arguing for them. And it is a subtle situation.

Mr. WITT. May I comment on the proposed amendment to the bill that is presently before the committee?

Mr. MAZZOLI. Please.

Mr. WITT. That is submitted not to indicate any favoritism towards the declaratory relief approach, but if it were to be determined that the declaratory relief approach is going to be used in any event, we think the modifications would be the minimum that we could live with.

Mr. DANIELSON. The modifications? Which modifications?

Mr. WITT. That I just submitted.

Mr. DANIELSON. Oh, the proposed amendment.

Mr. WITT. Right.

Mr. DANIELSON. I see.

Mr. MAZZOLI. Thank you very much, Mr. Chairman.

Mr. DANIELSON. Thank you.

I appreciate you gentlemen's help here. Concern was expressed that if the bill became law, that the provisions for injunction not be included. I can assure you that we are aware of that problem and we could, of course, tailor the bill to cover that problem as we saw fit. So I really wouldn't worry too much about the injunction procedure.

As a matter of fact, some of the proponents of the bill have already stated that they are not too much concerned about injunction. In sum, if we should have this procedure, you gentlemen all feel that some of those who are presently eligible to intervene should be able to intervene in the declaratory judgment proceeding, and by "some" I'm talking about persons like the cities who you represent, who are representing in turn the consumer in this particular instance.

Mr. PINES. That's correct.

Mr. WITT. Yes.

Mr. DANIELSON. I might say in passing that I thank you for trying to save me a little money on my phone bill. I'm as avaricious as anybody, and I wish you well, although I don't consider my wish to be enough to disqualify me on a conflict of interest here.

The issue seems to be, as has been apparent since our first hearing, that there is a question of whether the telephone company and the utility is eligible or is not eligible for the tax benefits of the accelerated depreciation and the investment tax credit. You people are satisfied that they are eligible for those benefits, even though there is a passthrough—they have the benefit despite a flowthrough to the consumers.

Mr. PINES. Some of the benefits.

Mr. AGNOST. Under the present plan, only 25 percent do.

Mr. DANIELSON. I know, but I suppose if you wanted to carry this to the extreme it could be all the benefits, could it not?

Mr. AGNOST. Normalization as defined in the code and the courts—and our courts feel that the normalization set up by the Commission pursuant to the court's direction will in fact preserve eligibility.

Mr. DANIELSON. That's right. That's what I'm trying to say. Your position is you feel that they are eligible for the tax benefit, even though some of the benefit flows through to the consumer.

Mr. AGNOST. Most particularly, Mr. Chairman, I would say we are prepared to defend their eligibility. And I think also that this whole proceeding doesn't lead anywhere unless it does lead to eligibility, which brings us back to the first position that Congressman Hughes advanced. We really should be asking for clarification from the Congress on this matter.

Mr. DANIELSON. Now, if I can continue with my inquiry, you do take the position that they are eligible for the tax benefit, even though all or part of the benefit flows through to the consumer?

Mr. AGNOST. Most assuredy.

Mr. SNAIDER. Yes.

Mr. DANIELSON. The telephone company takes the position that it is not sure whether it remains eligible if it passes through to the consumer?

Mr. SNAIDER. Yes and no. For purposes of rates, they have taken the position that they are ineligible. They have told us that when it comes to a tax adjudication——

Mr. DANIELSON. They contend that they are ineligible, but they are not sure that they are ineligible?

Mr. SNAIDER. But for purposes of tax adjudication—and we have been told this by Mr. Dalenberg, who told this to the commission—they will then say they are eligible and fight for their eligibility. So they have two positions, one for rate purposes, where they say we are ineligible, and one for tax purposes, where they are then going to turn around and say, we are eligible.

Mr. DANIELSON. But we're in an interlocking position now. Ultimately they have to take one position or the other, ultimately.

Their position is they do not know which option they're going to have to choose, ultimately. Isn't that basically what we're talking about?

Mr. AGNOST. That position depends upon whom they're facing, Mr. Chairman.

Mr. DANIELSON. But they still don't know for sure. Once the Internal Revenue Service makes a final determination that they are eligible or that they are not eligible, then that would resolve it, would it not?

Mr. SNAIDER. The courts, we believe.

Mr. AGNOST. It would, Mr. Chairman.

Mr. DANIELSON. The Internal Revenue Service and the courts. But when the Federal Government has ultimately spoken, and "ultimately" means there's nothing left, then that decision is final and binding, isn't that correct?

Mr. SNAIDER. Yes.

Mr. DANIELSON. Good. We finally got that pinned down.

At the present time I understand you to say that the telephone company has made a request of the IRS that they be declared ineligible?

Mr. AGNOST. In effect, yes. They sent a letter through Mr. Mortimer Caplin to the IRS asking if the IRS would agree that they are ineligible.

Mr. DANIELSON. When was that done?

Mr. SNAIDER. September 1977. We can provide a copy.

Mr. DANIELSON. I request that you do. Could you send it in at your early convenience?

Mr. DANIELSON. If they are declared ineligible, then the benefit would not be available for flowthrough to the consumer; is that true?

Mr. AGNOST. No. Their obligation to pay has been set up by the Supreme Court of California.

Mr. DANIELSON. But if they are ineligible for the tax benefit—now, assume we've gone to the supreme court. They are ineligible for the tax benefit. They then have no tax benefit to flow through, do they?

Mr. SNAIDER. That order would, of course, affect the back years. They could prospectively gain eligibility. But if they are ineligible, they can't flow it through. But subsequent action by the commission could resurrect their eligibility prospectively. In other words, it doesn't end forever once they were declared ineligible. That is only for the back years.

Mr. DANIELSON. Well, you mean the Internal Revenue is not bound in the future by what it ruled yesterday?

Mr. SNAIDER. No, the commission could change its methodology to give them prospective eligibility.

Mr. DANIELSON. But for the 6 or 7 years or whatever it is that we've got in the fire here, if the Federal Government makes an ultimate, irreversible decision that they are not eligible for the tax benefit, then they will have no tax benefit to pass through; isn't that true?

Mr. SNAIDER. Right, for those past years.

Mr. DANIELSON. Those are the only years we're talking about. We're not talking about 1912. There are no years I'm talking about except those years.

Mr. PEREZ. Mr. Chairman, just to clarify that one point, you are correct that $400 million that is sitting waiting to be refunded will be that benefit that we're talking about. We feel that that will be flowed through on the first of the year, approximately, and it will have already been taken care of.

Mr. DANIELSON. You mean talking about present circumstances?

Mr. PEREZ. Of those past 6 years.

Mr. DANIELSON. But if the ultimate decision of the Government is that there is no eligibility, they will in effect—this $400 million that they've got—or $400 million that they have available is illusory, because there isn't any benefit.

Mr. AGNOST. Not really, Mr. Chairman, because our commission, under the procedures of the court, would have to determine whether that loss of eligibility was because of a failure of the taxpayer to act with due prudence or not.

Mr. DANIELSON. My hypothesis is very clear, and we need not bend it further. I told you about an ultimate decision, an ultimate, and that really means ultimate.

Mr. AGNOST. Except, Mr. Chairman——

Mr. DANIELSON. What I'm trying to say is this: If they don't have a tax benefit, please tell me how they can pass it through?

Mr. HUGHES. Would the gentleman yield to me?

Mr. DANIELSON. Yes.

Mr. HUGHES. Maybe I can make some contribution. I am not certain, but as I understand it, once a decision is made to pass through, the benefits going to be passed through to the consumers. Now, if it is later determined that eligibility is to be denied because of the methodology used, then at that time the public utility commission, I would assume, would have to look at the utility's financial statements and its finances and then determine whether it is entitled to a rate adjustment prospectively.

Mr. DANIELSON. That is correct. But that isn't the same $400 million.

Mr. HUGHES. That's correct. Once that is passed through, that is passed through to consumers.

Mr. DANIELSON. At that point you pass through another $400 million charge on the consumers to make up for the portion.

Mr. HUGHES. Am I correct in my assumption that that is how the system works, I would assume in California, like most if not all of the States?

Mr. SNAIDER. There are two differences: One, the point you have said, Congressman Hughes, is right, that once the liability has been assessed, then the commission will look prospectively to determine what type of rates the phone company will be entitled to.

Mr. HUGHES. In the future.

Mr. SNAIDER. Yes, in the future.

Mr. HUGHES. But in the future means to address perhaps even previous decisions for rates that denied a fair and just return to the utility.

Mr. SNAIDER. I want to make this point clear, because I don't think we have. There is not permitted to be retroactive ratemaking. It can only take into account the fact that there is this major dollar amount that has gone out, say, in 1980 to pay the IRS. And you can certainly give them capital and cost of capital of that money. But you can't give them back something for the past.

Mr. HUGHES. I understand. But of course, what has happened in the past is going to determine the structure of the utility at the time that the PUC looks at it, and it would be on that basis that additional rates perhaps may be imposed, to try to provide for the capital structure of the company.

Mr. DANIELSON. To make up for that which they paid before. My difficulty here is—and I am trying to talk about absolutes, and you're talking about the future. And obviously, if the ultimate result of this whole controversy is that the phone company has paid out $400 million plus interest and then they find that they are not eligible to receive that $400 million, you've got to make a rate adjustment in the future to put them back on the track into their proper fiscal position.

Mr. MAZZOLI. Mr. Chairman.

Mr. DANIELSON. Yes.

Mr. MAZZOLI. May I ask a question, and it probably shows you that I am not up on the facts here. but those $400 million, is not that money which has been taken from the phone users of the State of California?

Mr. SNAIDER. This has been collected.

Mr. MAZZOLI. It has been transferred; it's been in the coffers. What they've done with it, that's money that the people of California coughed up, which some court said they should not have had to cough up in the first place because of some accounting transaction or lack thereof.

Mr. PINES. That's right.

Mr. MAZZOLI. What you're saying here, as I understand it, is that $400 million ought not be held hostage because of anything else that we're doing; any further clarification, any prospective change. The people of California, in equity and in law, are entitled to a return of x amount of that $400 million. What you guys do, what this Congress does, what the Tax Court does, what the Supreme Court does, is a separate question. This is a matter of equity and law. That money has been paid. Is that anywhere near the case?

Mr. PINES. That's exactly it.

Mr. SNAIDER. It has been collected subject to refund since 1974 and subject to Pacific's representation that they were financially capable of refunding anything.

Mr. DANIELSON. You say that "are capable"?

Mr. SNAIDER. They represented that to the Supreme Court.

Mr. MAZZOLI. This $400 million is not monopoly play money; it's cold cash which has been paid over to somebody the court said should not have received it.

Mr. PEREZ. That is correct.

Mr. DANIELSON. Well, the whole purpose of this bill, the problem here, is that it still gets back to the question of eligibility. Is the telephone company eligible for the tax deduction? Because if they are found to be not eligible for the tax reduction, then they would owe that money to the U.S. Treasury.

I think you missed that, Ron. This is true this is money turned in, but the question turns on eligibility for a tax benefit. If the final decision is that they are not eligible for the tax benefit, then that same $400 million has to be paid into the U.S. Treasury as a tax.

Mr. MAZZOLI. And then it is up to the PUC to decide whether or not there should be rate adjustments to make compensation for it. And that is a question we can't decide; this group can't decide. Only the PUC can do it subject to whatever court review it is entitled.

That is the problem, Mr. Chairman. I think we can't get too far ahead of ourselves.

Mr. DANIELSON. But the point is that it has taken several years to come to a decision on eligibility, and the telephone company seeks to have a new remedy created which would enable them to go into court and get declaratory relief under which the court would rule that, "Yes, you are eligible," or "No, you are not eligible," whatever the case may be.

Mr. PEREZ. And, Mr. Chairman, I might add it is very important to understand that that declaratory ruling, whatever it might be, is subject to appeal. Now, that appellate process might take us right back up to the Supreme Court again and, in fact, take longer than if we let the IRS take their issue to the Tax Court.

Mr. DANIELSON. Sir, that is true, but you're saying that in the context of this particular controversy. It could be that next year a new one will pop up in North Carolina or Utah or someplace, and, as the gentleman from the Treasury said this morning, if declaratory relief had been an available remedy at the inception, this might have been disposed of sometime ago. But it wasn't available, and, as a result, it dragged.

Mr. HUGHES. Mr. Chairman?

Mr. DANIELSON. Yes.

Mr. HUGHES. Apparently, the initial judgment was entered in 1971, as I understand, in the testimony, but the litigation by and large has been over the question of whether or not the methodology used by the utility qualifies the utility for the investment tax credit and the accelerated depreciation and what have you. The litigation has not really been directed at the question of eligibility before the Federal courts, as I understand it. Is that correct?

Mr. PINES. Yes; it has been a ratemaking issue, not an eligible-tax issue.

Mr. HUGHES. And it is your testimony that the request of the commissioner of the Internal Revenue Service by the utility for a clarification on this point was sort of a weak request which was not the

combative type approach that you feel the utility should have taken. You're going to submit for the record the letter that was submitted to the Internal Revenue Service requesting that determination?

Mr. PINES. Yes; Mr. Chairman, again, if I may respond, that is also a concern about a declaratory judgment action, that is, of an interlocutory nature.

Mr. HUGHES. I think you have been making that point quite strongly and vividly, and, obviously, the matter would not be where it is today if you had not very diligently pursued what you felt was a right that should have been available to the citizens of California. And I understand that point, and I think you make a valid point when you say that, by excluding all parties except the PUC and the utilities, that you're going to be excluding, perhaps, the real party at interest, and that is the people of California who you feel would have no strong voice in that type of proceeding.

But the question I have is—and I think you have made the point—that up until now there really hasn't been a very vigorous effort to get a clarification of the IRS's position on eligibility.

Mr. DANIELSON. Are you stating that you feel the telephone company has been dilatory in seeking a clarification?

Mr. AGNOST. Exactly, Mr. Chairman. Speaking for San Francisco, we feel that it is very much the case.

Mr. PINES. The letter speaks for itself. It is a very weak request.

Mr. DANIELSON. Well, we haven't seen the letter yet, but I am sure we will.

Mr. PINES. It is obviously in the phone company's interests, before they really have to fork over a refund, to argue for loss of eligibility, to take the position that they're going to lose eligibility, because that way they don't have to make the refund.

Mr. DANIELSON. But they would have to pay the tax.

Mr. PINES. No, not if there is never a refund made. They will never have to pay the tax. As I say, they get their cake and eat it, too. They accumulate the capital as a result of the tax savings.

Mr. DANIELSON. If they are ineligible, do they accumulate capital if they are not eligible?

Mr. PINES. No, but if they get a preliminary ruling from the IRS that if the PUC orders these refunds they will lose eligibility, they are in the best of all worlds: They can try to stop the PUC from giving those refunds and therefore preserve their eligibility. So, as I said, they get the benefits, but they don't have to pass them on to the consumers.

Mr. DANIELSON. But do they have to pay the tax then?

Mr. PINES. No.

Mr. DANIELSON. If they're not eligible for the tax benefits, they do not have to pay the tax?

Mr. PINES. They don't have to pay a tax simply because the IRS has given them a tentative ruling that if such-and-such an event occurs, they will lose eligibility. They don't have to pay the tax until they have actually lost eligibility by the payments of the refunds.

Mr. SNAIDER. Mr. Chairman, the only thing that could trigger ineligibility is actually paying out the rate refunds, because they would be ineligible, assuming their legal theory was right, because they paid the rate refunds.

Now, as long as you delay the rate refunds, which they've been doing for years, there is no way they could be declared ineligible because their taxes, their rates are being collected on a matter which they themselves say are eligible. So, without getting into the real controversy and paying the refunds, you can't get any adjudication.

Mr. DANIELSON. Suppose they pay the refund and are then declared ineligible. Do they then have a tax liability based upon—they do have a tax liability then?

Mr. SNAIDER. I think we could agree with that.

Mr. DANIELSON. So, they do have one, then.?

We have overlooked the gentleman from Virginia.

Mr. HARRIS. I have no questions, Mr. Chairman.

Mr. DANIELSON. Does anyone else have a question of this panel?

[No response.]

Mr. DANIELSON. Thank you very much for your help. You have been very helpful to us. And we will look forward to receiving the letter and also the proposed or suggested changes in the revenue code. Thank you very much.

And Mr. Pines, Mr. Moorhead expressed to me regret that he could not be here, but he is doing another job elsewhere. Thank you.

We now will call on—I am trying to get the out-of-town witnesses first, if I can—Ms. Janice Kerr, of the California Public Utilities Commission.

Ms. Kerr, we have a statement from you, and it will be received into the record, which will leave you free to just debate your points in the most effective manner.

[The summary statement of Ms. Kerr follows:]

SUMMARY OF STATEMENT OF JANICE E. KERR, PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA ON H.R. 229

As stated in the presentation by Mr. Chandler on August 2, 1979, California strongly supports the main thrust of H.R. 229, that is, the provision for declaratory relief in certain federal tax matters.

Since the August 2 hearing Justice Rehnquist of the United States Supreme Court declined to stay the California Public Utilities Commission's disputed rate order on the grounds that the matter had already been considered and certiorari denied by the full Court.

Mr. Justice Rehnquist's opinion makes note of the traditional separation of powers between the Federal and State governments. His views underscore California's main concerns with H.R. 229, that it could either directly or inadvertently work to stay or enjoin a ratemaking order issued by a duly constituted state regulatory agency.

California submits four amendments to solve this problem as well as others noted in Mr. Chandler's statement.

California is hopeful that these amendments will be adopted so that we may continue our suport of H.R. 229.

STATEMENT OF JANICE E. KERR, GENERAL COUNSEL, PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA ON H.R. 229

Mr. Chairman and Members of the Subcommittee, my name is Janice E. Kerr. Since 1977 I have been General Counsel of the California Public Utilities Commission. Prior to that time I served on the Commission's legal staff for twelve years. I am authorized to present to the Subcommittee amendments to H.R. 229. Adoption of these amendments would solve the problems raised by California in its presentation at the hearing on August 2. These amendments have also been endorsed by the National Association of Regulatory Utility Commissioners.

My purpose today is to bring to the attention of the Subcommittee events which have transpired since the last hearings, to affirm our support for declara-

tory relief and to reiterate with greater specificity our concern that this bill might inadvertently create a mechanism for injunctive relief.

First, and most importantly, Justice Rehnquist, on August 13, 1979, denied the application of the telephone companies for a stay of the California PUC's order, He characterized the companies' actions as "an effort to relitigate issues which had been determined adversely to them by the administrative and judicial processes of the State of California." He stated that the claims of the company were "entirely a matter for the State to decide." This is important because it enunciates once again the separation of powers clearly stated in the Constitution and in Congressional enactments such as the Johnson Act. In considering the sort of judicial mechanism that might be created by this legislation, Justice Rehnquist's admonition against federal stays of state administrative orders should be borne in mind. The first of the amendments attached below speaks directly to this issue. Justice Rehnquist's decision is attached to my statement.

Second, several days subsequent to Justice Rehnquist's decision, the telephone companies filed with the Commission plans to refund $400 million to California consumers or $30 to $40 to every household in California. This is consistent with the Commission's order, which we believe will be upheld as consistent with eligibility when litigated.

On August 2, Mr. Chandler set forth California's concerns with regard to H.R. 229. Unless the bill is amended, we vigorously oppose it. The amendments which I now discuss have been endorsed by the National Association of Regulatory Utility Commissioners. Their Resolution of Support is attached to my statement. California's amendments are as follows:

REQUIRED AMENDMENTS

I. Preservation of role of State courts

As presently written, the legislation may, by virtue of provisions of existing law (28 US Code § 2202) form a basis for provision of injunctive relief by federal courts against a state rate-making body. These provisions of existing law state that "Further necessary or proper relief based on a declaratory judgment may be granted . . . against any adverse party whose rights have been determined by such judgment." Long-standing federal policy under the Johnson Act (28 USC § 1342) has dictated that any such relief be sought in the state courts. A change in this policy would significantly erode traditional state ratemaking powers, and raise grave constitutional issues under the Tenth Amendment. Rover V. R. Dalenberg, appearing before the Judiciary Subcommittee on Administrative Law and Governmental Relations on August 2, 1979, on behalf of the Pacific Telephone Company, indicated that the sole purpose of the bill is to provide information for state regulatory bodies. In order to clearly limit the scope of the bill's effect to that goal, and to avoid the inadvertent creation of an injunctive mechanism where none is intended, the following amendment is proposed:

"§ 2202(d): Notwithstanding any other provisions of Chapter 151 of Title 28, United States Code (Declaratory Judgment Act), in connection with any action brought under this section, the district court shall not enjoin, suspend or restrain the operation of, or compliance with, any order affecting rates chargeable by a public utility and made by a state administrative agency or a ratemaking body of a state political subdivision."

II. Clarification of scope of declaratory judgment

The purpose of the legislation is to provide a binding determination of the effect of proposed accounting methods on a public utility's eligibility for accelerated depreciation, investment credit, and asset depreciation range tax benefits. The current wording of the legislation does not clearly limit its scope to such determination. The following amendment is therefore proposed:

"In § 2202(a), strike the words 'with respect to the ratemaking or accounting provisions of Section 46(f), 167(1), or 167(m) of the Internal Revenue Code of 1954,' and insert in lieu thereof the words: 'with respect to a public utility's eligibility for the use of accelerated depreciation range arising out of the provisions of Sections 167(1), 46(f), or 167(m) of the Internal Revenue Code of 1954.'"

III. Broadening of legislation to include all parties to a ratemaking proceeding

Many times disputes over a utility's eligibility for tax benefits arise out of the claims of third parties. The California dispute, for instance, arose when an intervenor sued both the ratemaking body and the public utility. It would be desirable from the standpoint of efficiency and fairness to insure that such intervenors be

unable to claim that they are not included within a federal court's declaratory judgment. In order to insure that all parties to a ratemaking proceeding have equal access to judicial processes affecting ratemaking, the following amendment is proposed:

"In § 2202(a), strike lines 14 through 20, and insert in lieu thereof the words 'pleading for a declaratory judgment may be filed by any party to a ratemaking proceeding. In any case arising out of this provision, the Secretary of the Treasury and all parties to the ratemaking proceeding giving rise to the case shall be joined as parties in the action.'"

IV. Exercise of administrative rights

The legislation currently provides that no declaratory judgment may be issued unless the public utility requests a ruling from the Secretary of the Treasury. This may inadvertently make moot the provision of the legislation for bringing of suits by ratemaking bodies, and the provision for third-party suits proposed in Amendment III above. Merely by failing to request such a ruling, the public utility could block the suit. This can be remedied by limiting the ruling requirement to suits brought by the public utility. The following amendment is therefore prepared:

"§ 2202(b): Insert after the word 'case' in line 22 the words 'brought by a public utility.'"

An alternative approach would be to require the utility to seek such a ruling if it is served notice of the intent of another party to a ratemaking proceeding to seek a declaratory judgment. This approach may be unnecessarily complex, since provision of penalties may be necessary.

Thank you.

SUPREME COURT OF THE UNITED STATES

NOS. A–101 AND A–102, ON APPLICATIONS FOR STAY

A–101 PACIFIC TELEPHONE & TELEGRAPH CO., PETITIONER,

v.

PUBLIC UTILITIES COMMISSION OF CALIFORNIA, ET AL.

A–102 GENERAL TELEPHONE CO., PETITIONER,

v.

PUBLIC UTILITIES COMMISSION OF CALIFORNIA, ET AL.

[August 13, 1979]

Mr. Justice Rehnquist, Circuit Justice.

Applicants request that I continue in effect a temporary injunction issued by the Court of Appeals for the Ninth Circuit on April 2, 1979, pending disposition by the full Court of their petitions for certiorari to review the judgment of the Court of Appeals. On July 18 that court, in a consolidated case in which both applicants were appellants, affirmed the judgment of the United States District Court for the Northern District of California denying applicants' injunctive relief against the enforcement of a rate order earlier promulgated by respondent California Public Utility Commission (PUC). The PUC in September 1977 (Decision No. 87838), had ordered applicants to refund charges paid by subscribers before 1978 and to reduce certain of its rates for that and future years. The PUC, however, stayed implementation of its order pending judicial review. *Pacific Telephone & Telegraph Co.* v. *Public Utilities Comm'n*, No. 79–3150, slip. op., at 2 (CA9, July 18, 1979).

After the Supreme Court of California denied applicants' request for review, applicants petitioned this Court for certiorari. Applicants argued this Court should review the PUC rate order because it was premised on the PUC's interpretation of an unsettled question of federal tax law. They claimed that if this interpretation subsequently proved incorrect, they would be subject to substantial liability in back taxes. Applicant Pacific Telephone also challenged the PUC's decision on the ground that it violated the Due Process Clause. The petitions were denied on December 12, 1978. 439 U.S. 1052, with Mr. Justice Marshall and Mr. Justice Blackmun dissenting from the order of denial. Petitions for rehearing were thereafter denied on February 21, 1979. 440 U.S. 931. On March

14, 1979, the PUC terminated the stay of its own order of September 13, 1977, stating in its order so doing that "the avenues of judicial review have been exhausted." *Pacific Telephone & Telegraph Co., supra*, slip op., at 2. The following day applicants filed a complaint for declaratory and injunctive relief in the United States District Court for the Northern District of California. That court denied relief, but the Court of Appeals granted its own temporary injunction on April 2, 1979, pending consideration of applicants' appeal from the order of the District Court. Last month, as previously noted in this opinion, the Court of Appeals affirmed the judgment of the District Court, dissolved its own injunction, and denied applicants' request for a stay of mandate in order that they might petition this Court for certiorari.

With this sort of procedural history, one would expect applicants' petitions for certiorari to deal principally with questions arising under the United States Constitution or laws governing the setting of rates by state utility commissions for public utilities. But the questions which applicants seek to have reviewed on certiorari pertain to the application of federal tax statutes as they relate to depreciation which may be claimed by public utilities. Since it is this type of question which applicants seek to litigate if certiorari is granted, one would likewise expect either an agency or officer of the United States having some responsibility for administering these tax statutes named as respondents, instead of the California PUC or intervening California municipal corporations. Without dwelling further on the anomalous nature of applicants' petitions for certiorari, I have concluded that their actions in the United States District Court for the Northern District of California begun in March 1979, were simply an effort to relitigate issues which had been determined adversely to them by the administrative and judicial processes of the State of California, and with regard to which this Court denied certiorari and denied rehearing last Term. 439 U.S. 1052 (1978); 440 U.S. 931 (1979). These denials took place notwithstanding the fact that the Solicitor General urged the Court to grant certiorari and decide the issues presented by the petitions.

The PUC in its Decision No. 90094, rendered on March 14, 1979, after the proceedings in this Court, was doing no more than formally stating that the conditions on which its stay had been granted—exhaustion of judicial review—had occurred, and therefore the stay expired by its own terms. The PUC dissolved this stay despite applicants' contention that the PUC's interpretation of federal tax law in Decision No. 87838 was incorrect and that the rate order would consequently result in the IRS's assessment of substantial tax deficiencies against applicants. In my opinion, the determination of whether or not the PUC's rate order should have been stayed pending resolution of the federal tax issues was, at this late stage in the proceedings, entirely a matter for the State to decide.

One need not question the assertion of applicants that very large financial stakes hinge on the manner in which the IRS, subject to whatever review of its action is provided by law, treats the refund and rate reduction orders imposed by the PUC's order of September 13, 1977. Nor need one doubt that this Court had jurisdiction, under cases such as *Zacchini* v. *Scripps-Howard Broadcasting Co.*, 433 U.S. 562 (1977), to review applicants' earlier petitions for certiorari in Nos. 78–606 and 78–607, O. T. 1978, on the ground that the PUC had reached a decision based on a misapprehension of federal law which it might not have reached had it correctly understood federal law. But that is now water over the dam. This Court denied those petitions last Term, and denied petitions for rehearing.

If I thought it necessary in passing upon this stay application to determine the present day correctness of this Court's reading of California law in *Napa Valley Co.* v. *Railroad Commission*, 251 U.S. 366 (1920), I would naturally defer to the opinion of the Court of Appeals, which must deal with California law more frequently than does this Court. But I do not actually think it is necessary to make this determination; a State may enunciate policy through an administrative agency, as well as through its courts, and so long as there is an opportunity for judicial review the fact that such review may be denied on a discretionary basis does not make the agency's action any less the voice of the State for purposes of this Court's jurisdiction or for purposes of federal-state comity. See *United States* v. *Utah Construction Co.*, 384 U.S. 394, 419–423 (1966). Nor is this a case where any claim of bias is made against the agency, see *Gibson* v. *Berryhill*, 411 U.S. 564 (1973), or where an action of the federal courts in refusing to allow applicants to relitigate the merits of their claim on which

this Court has previously denied certiorari amounted to the imposition of a requirement of "exhaustion of administrative remedies." Here the administrative action was the source of the claimed wrong, not a possible avenue for its redress.

The net of it is that I believe applicants' federal court litigation is new wine in old bottles. When it was new wine in new bottles, last Term, this Court denied certiorari, and I have no reason to believe that any intervening events would change that outcome. Accordingly, without considering the second part of the requirement which applicants must meet in order to obtain a stay—the so-called "stay equities"—the temporary stay which I previously issued is dissolved forthwith, and applicants' request for a stay of the mandate of the Court of Appeals for the Ninth Circuit hereby

Denied.

Dated in Washington, D.C. this 13th day of August, 1979.

RESOLUTION RE DECLARATORY JUDGMENTS RESPECTING FEDERAL INCOME TAXES

Whereas, no court of the United States may by law issue a declaratory judgment with respect to Federal taxes, and H.R. 229 (96th Cong., 1st Session) would delete this provision of law with respect to declaratory judgments regarding Sections 46(f) and 167(l) and (m) of the Internal Revenue Code; and

Whereas, H.R. 229 could provide for an early determination of significant Federal income tax questions and hence would be in the interests of both utilities and ratepayers; and

Whereas, H.R. 229, as introduced, first, does not limit declaratory judgments to interpretation of tax statutes only, but could apply to questions of intrastate ratemaking properly within an area of state jurisdiction; second, provides only that the affected public utility or regulatory agency may seek a declaratory judgment thereby omitting other interested parties representing various customer classes; third, is limited to the questions arising under Sections 46(f) and 167 (l) and (m) of the Internal Revenue Code only, thus excluding from its scope all other potential Federal tax questions; and, fourth, does not preclude the stay of a state regulatory proceeding pending conclusion of an action for declaratory judgment or such a stay pending a further Federal action based on such declaratory judgment pursuant to 28 U.S.C. 2202, either or both of which would permit nnacceptable interference with state proceedings and orderly procedures and would be contrary to the Federal policy of non-interference with state regulatory proceedings embodied in the Johnson Act (28 U.S.C. 1342: Now, therefore be it

Resolved, That the Executive Committee of the National Association of Regulatory Utility Commissioners recommends that Congress favorably consider H.R. 229 (96th Congress, 1st Session) with appropriate modifications to limit the operation of H.R. 229 to questions of interpretation of Federal tax statutes only and not questions of intrastate ratemaking; to authorize other interested parties as well as utilities and regulatory agencies to seek declaratory judgments; to provide for declaratory judgments under all provisions of the Internal Revenue Code; to preclude any stays of a state regulatory agency proceeding or decision pending conclusion of an action for a declaratory judgment, or a subsequent Federal action based on such declaratory judgment; and to provide that such bill not constitute an abrogation or modification in any respect of the Johnson Act (28 U.S.C. 1342).

TESTIMONY OF JANICE E. KERR, PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Ms. KERR. Fine. Thank you very much. My name is Janice E. Kerr. I am the general counsel of the California Public Utilities Commission. We do appreciate the opportunity to appear here before you again today.

We have brought several amendments which we believe will solve the problems which were raised by California in its presentation on August 2. My prepared material also updates the committee on the status of the disputed tax matter in California.

If I can leave you with one thought today, it would be that California does enthusiastically support the provision for declaratory relief

in Federal tax matters affecting utility regulation. As various members at the table have stated today, we have lived with this problem for about 11 years. We expect to live with it in the near future, and the ability to obtain declaratory relief would be an invaluable aid to the commission.

I can well anticipate recommending that the commission make use of that relief, were the utilities to eschew it. Under no circumstances, however, can California support H.R. 229 if it would work to stay or enjoin a State rate order. Therefore, in order to make the purpose of the bill clear, we would propose an amendment which would specifically state that it does not provide the basis for injunctive relief. And that is the first amendment which is included in my prepared material.

As I understand Mr. Dalenberg's statement—and I believe you made mention of this, Mr. Chairman—this amendment should not be opposed by the telephone companies. He originally had proposed an amendment which would have provided for injunctive relief, and then withdrew that amendment as not being critical to the bill.

We must oppose the possibility of an injunction because that would directly impair the powers of the State regulatory agency, and this would, of course, be contrary to the principles of the Johnson Act and certainly anathema to the historical separation of State and Federal power. The idea that utility rate regulation is the sole province of the States was strongly confirmed by Justice Rehnquist in his recent opinion issued August 13 in the disputed tax matter and his opinion is attached to my statement also. We also strongly believe that without the participation of the traditional intervenors in this case—the cities and other consumer groups in California——

Mr. DANIELSON. You say you favor that or do not favor that?

Ms. KERR. We do favor that. We believe that that would be an expeditious way to resolve the problem, if the declaratory relief bill is enacted.

Without their participation before the Federal courts, I can see an endless stream of litigation.

That concludes my statement. We are hopeful that the bill will be amended. We are hopeful that it will be adopted. And, as I say, we will have to oppose it unless it is more specifically amended to provide that it does not provide the basis for injunctive relief.

Mr. DANIELSON. Thank you very much, Ms. Kerr. You have boiled it right down to the essence, and that is really a great deal of help to us.

As I understand it, you would favor this bill, provided that the provisions for injunction were stricken and further provided that the affected third-person intervenors would be permitted to be parties to the action.

Ms. KERR. That is correct.

Mr. DANIELSON. Is that about it, in essence?

Ms. KERR. That is correct. And I should say with regard to the injunction provision, that the bill specifically states that it does not provide the basis for an injunction, not that it remains silent.

Mr. DANIELSON. I don't think we would have to go that far. I know that it makes you nervous, but let me reassure you that there is no need to be nervous. If we don't provide for an injunction, there is not going to be one, and we can take care of that.

But I do appreciate it. You have stated your case extremely well, and without an absolute lack of obfuscation. And I appreciate that.

And I would yield to the gentleman from Virginia.

Mr. HARRIS. No questions, Mr. Chairman.

Mr. DANIELSON. Mr. Mazzoli, of Kentucky?

Mr. MAZZOLI. Mr. Chairman, no questions.

Thank you very much for your statement.

Mr. DANIELSON. Mr. Hughes?

Mr. HUGHES. Thank you, Mr. Chairman.

Just a question. I wonder if you would have an opinion as to whether or not we shouldn't be looking at the Internal Revenue Code instead of trying to set up a new procedure?

Ms. KERR. I agree wholeheartedly that we should be looking at that, and I commend the discussion this morning, and we would certainly join in that effort.

However in the alternative, we also believe that the declaratory relief bill, H.R. 229, is a valuable avenue.

Mr. HUGHES. Thank you, Mr. Chairman.

Mr. DANIELSON. You've answered it.

Ms. KERR. Thank you.

Mr. DANIELSON. It's a good thing you don't work by the hour. You wouldn't get enough pay.

[Laughter.]

Mr. DANIELSON. Thank you very much.

Our next witness will be Mr. Brian Lederer, attorney for the District of Columbia People's Counsel.

[The summary statement of Mr. Lederer follows:]

SUMMRY SHEET OF THE PEOPLE'S COUNSEL OF THE DISTRICT OF COLUMBIA

While the proposed legislation appears simple and reasonable, it has a number of serious problems which justify its rejection. Tbese problems are (1) it aggravates a serious conflict between federal tax policy and anti-inflation policy; (2) it preempts a utility commission in its determination of just and reasonable rates; (3) it stimulates capital formation without regard to need; (4) it deals with a problem less than real, tbe consequences of nncertainty associated witb possible disallowance of certain tax claims if associated ratemaking policies are not allowed; (5) it does not present need for an exemption from the general policy against declaratory judgments in tax cases; (6) the bill cannot avoid the problem of the Johnson Act prohibition and the policy thereunder against federal court injunctions directed at state public service commissions; (7) the bill may be unconstitutional in that it represents an unconstitutional intrusion on state sovereignty and an unconstitutional denial of due process to the rate payer, a necessary and indispensable party in the determination of just and reasonable rates; (8) the real purpose of the legislation is to ultimately prevent a public service commission from making a judgment as to the level of capital needed by a utility and whether the public service commission ought to force compulsory interest-free loans from the rate payer to tbe investor.

TESTIMONY OF THE PEOPLE'S COUNSEL OF THE DISTRICT OF COLUMBIA

Mr. Cbairman, Members of the Committee, I appreciate very much the opportunity to testify before you on H.R. 229 to amend Title 28, U.S. Code, to provide for Declaratory Judgment in Federal Court of certain tax issues involving public utilities.

My name is Brian Lederer. I am the People's Counsel of the District of Columbia. By law I represent all of tbe rate payers of the city, including tbe business community, tbe governmental institutions, and the residential customers. I was nominated by the Mayor witb tbe advice and consent of the City Counsel. Tbe jurisdiction of tbe Office of tbe People's Counsel includes gas, telepbone, and

electric utilities. The Office has substantial experience in complex utility issues, including the matter of taxes and rates.

I come before you in order to ensure that there be a timely and complete record concerning this proposed legislation.

This bill affects matters of profound economic importance to the country. Its implications ought to be very carefully examined before any action, if any, is taken on this bill.

While this proposed legislation appears simple and reasonable, in my view, it in fact addresses a problem that is more illusory than real and would create a series of very unfortunate problems. This is a good example where the cure is far worse than the disease, to use an old cliche.

This legislation, if adopted, would aggravate existing conflicts between tax policy and anti-inflationary policy. Coincidental with the decade of rapid inflation, federal tax policy has been moving toward promoting interest-free capital formation by public utilities by authorizing tax-saving elections for depreciation, repairs and investment. The issue is not the tax devices but the attempt to direct public service commissions to allow, as a current income tax expense, differences between taxes paid and those recorded on a public utility's books, as "deferred taxes."

As I said initially, this bill appears simple and reasonable. All it proposes to do on the face of it is to allow a public utility or a public service commission to have a declaratory judgment in the event of a particular controversy over specific tax issues between the public utility and the tax authorities, or between the public utility and the public service commission. The court hearing would concern ratemaking or tax accounting questions arising from sections of the Internal Revenue Code pertaining to public utilities and the investment tax credit, accelerated depreciation, and depreciation class lives.

In addition to the serious conflict between tax policy and anti-inflationary policy, this so-called simple and reasonable bill would have other devastating problems. Such a collection is, in effect, a mandatory interest-free capital investment by the rate payer. This capital formation would occur whether or not it is needed. Thus, the tax policy to promote it may very well be inflationary.

It would preempt state utility commissions in an area that is at the heart of the ratemaking authority. Public service commissions across the country are charged with setting just and reasonable rates based on record evidence. The issue herein involves a determination by a commission on the proper federal income tax amount to be recovered in rates and involves millions of dollars per utility. The ratemaking question is whether or not federal income taxes collected in rates will be inflated to permit the collection of taxes that are not in fact paid during the ratemaking test year.

The practical effect of this legislation would be to allow the utilities a forum other than the public service commission in which to have the ratemaking tax issue decided. As a result, the determination of whether or not just and reasonable rates requires the collection of unpaid taxes in the test year will be preempted. In other words, a public service commission would be precluded from exercising its discretion.

The rate level differences between types of tax treatment are not trivial. In a recent Pepco rate case, the company requested full tax normalization. The company projected that if full tax normalization were granted, it would produce $50 million of cash flow to the utility not reflected in earnings.

This legislation, if approved, would push federal tax policy further in the direction of stimulating capital formation without regard to need. Furthermore, the legislation would prevent a public service commission, in the exercise of its discretion, from minimizing the inflationary ratemaking impact of such a policy push.

Another problem with the proposed legislation is it deals with a problem that is less than real. The utilities allege "uncertainty" concerning what the Internal Revenue Service would do if the utility elected some form of accelerated depreciation or the investment tax credit and the public service commission did not permit the collection of the so-called deferred taxes associated therewith.

The public utility argues that unless the public service commission allows the collection of those "deferred taxes," the Internal Revenue Service may disallow the claim of the investment tax credit, the accelerated depreciation repaid allowance, or the accelerated depreciation claim itself. The answer is, "so what?"

If the refusal of a public service commission to allow the collection of such unpaid taxes results in an Internal Revenue Service disallowance of certain

tax claims and a consequent higher tax liability for a utility, who is to say that the utility will not be allowed to collect those subsequently higher taxes from the rate players? Actual taxes paid are a legitimate expense of a utility. In fact, illegal ratemaking for a public service commission probably would be to deny a utility the collection of actual taxes paid.

There is no need for an exemption from the general policy against declaratory judgments in tax cases. One area in which such judgments have been allowed, the determination of eligibility for 501(c)(3) charitable corporations, resulted from a true threat to the existence of such organizations from challenges to their tax exempt status or uncertainty about their tax exempt status.

A further problem is that a Declaratory Judgment obtained by a public utility in one of these tax normalization cases would be useless without the ability to enforce such a judgment against the public service commission by means of an injunction. This enforcement would run counter to the Johnson Act prohibition against injunctions in Federal District Courts directed at state public service commissions concerning rate orders.

In addition, this legislation may very well be unconstitutional for two fundamental reasons: First, it may be part of an unconstitutional intrusion on the sovereign authority of each state to decide what accounting or ratemaking procedures best serve the needs of its citizens.

Second, the legislation, without any justification whatsoever, would eliminate the rate payers as a party from a Declaratory Judgment lawsuit. The rate payer is a party to every rate proceeding and has a strong justiciable interest in the outcome of any such Declaratory Judgment concerning federal tax and state ratemaking policies. Such a party is a necessary, if not indispensable, party to a rate proceeding. If the rate payer is denied an opportunity to present argument in a Declaratory Judgment lawsuit, it could very well constitute deprivation of property without due process.

Finally, one must understand that the real purpose of this legislation is part of a process to prevent a public service commission from making a judgment as to the level of capital needed by a utility and whether the commission ought to permit the compulsory collection of interest-free capital from the rate payer to the utility and, if so, how much. Not only does this deprive a public service commission of a crucial judgment necessary for determining just and reasonable rates, but also it permits public utilities to force a public service commission to approve rates which may very well be inflationary.

There are several consequences to an ability by a public utility to force approval of rates containing tax normalization. First, it would encourage unnecessary construction by utility companies by removing the economic barriers of capital acquisition which would ordinarily inhibit nonessential construction. Second, it would fail to stimulate a competitive market place for money, and so would do nothing to hold down rates.

I very much appreciate this opportunity to testify and to help complete the record on this proposed legislation.

TESTIMONY OF BRIAN LEDERER, ATTORNEY, PEOPLE'S COUNSEL OF THE DISTRICT OF COLUMBIA

Mr. DANIELSON. Mr. Lederer, thank you very much. We could not reach you at the last meeting. I am sorry. You being a hometown person; we try to give preference to those who have to travel long distances.

Mr. LEDERER. I understand, Mr. Chairman. I think it's only a $1.30-taxi ride up here, as opposed to a $400-airplane trip.

Mr. DANIELSON. You can come up on the Metro.

Mr. LEDERER. Yes, I can. That's only 50 cents.

Mr. DANIELSON. We have one of the "fathers" of Metro over here.

Mr. LEDERER. We have jurisdiction over taxi rates, so I have to know what is happening with them.

Mr. DANIELSON. I see.

Your statement likewise will be received in its entirety into the record, and you may go ahead and argue your case.

Mr. LEDERER. Thank you, Mr. Chairman.

What I will do here is use part of my statement and then, reflecting the fact that it is in the record, omit other parts.

My name is Brian Lederer. I am People's Counsel of the District of Columbia. By law, I represent all the ratepayers of the city, including the business community, the governmental institutions, and the residential customers.

Mr. DANIELSON. You are the counterpart of what we call in California the "city attorney." Is that not right?

Mr. LEDERER. Except that jurisdiction is limited to public utilities.

Mr. DANIELSON. I see.

Mr. LEDERER. And in this instance, the Peoples Counsel of the District of Columbia is nominated by the Mayor with the advice and consent of the City Council. So that is another distinction. The jurisdiction of the Office includes gas, telephone, and electric utilities, and the Office has substantial experience in complex utility issues, including the matters of taxes and rates.

Also, I am a member of the executive committee of the organization called the National Association of State Utility Consumer Advocates, which is composed of persons like myself similarly situated to represent the public in States such as Ohio, South Carolina, Florida, New York, Utah, Idaho, and so forth. And the organization, while not going officially on record, has unofficially expressed serious concern about the impact that this bill could have on the ratemaking efforts of the public councils in the various States.

This bill, in our view—in my view—affects matters of profound economic importance to the country. We go from great detail, in a sense, to great generalities or to issues that have broad, sweeping impact, and we shouldn't lose sight of the sweeping impact even though the details are critical. This legislation addresses a problem that is more illusory than real and, in my view, would create some unfortunate problems that have not been heretofore addressed.

In particular, it would aggravate existing conflicts between tax policy and anti-inflation policy. Coincidental with a decade of rapid inflation, Federal tax policy has been moving toward promoting interest-free capital formation by public utilities by authorizing tax saving elections for depreciation, repairs, and investment. The issue is not the tax devices themselves, but the attempt to direct State public service commissions through the Federal tax laws to allow as a current income tax expense differences between taxes actually paid and those recorded on a public utility's books as "deferred taxes."

Such a collection amounts to a mandatory interest-free capital investment by the ratepayer. This capital formation would occur whether or not it is needed. This is a pertinent point to keep in mind as the committee considers legislation because there is an assumption that this capital formation is all productive and needed. In our experience, we have discovered it is not. That is why it becomes an issue of ratemaking jurisdiction for the commissions, and I will address that a little further.

Thus, what we have is tax policy that promotes capital formation, by directing higher State utility rates—regardless of the need for the capital formation. Thereby we have a tax policy that is inflationary.

The question was asked of earlier witnesses, how could the Congress help deal with the problem that he telephone companies of California have raised?

One way it could is by amending the tax law to remove state ratemaking requirement of normalization to be eligible for Federal tax benefits. If a company elects these various capital formation techniques, leave the decision as to the ratemaking judgment to the commission based on the commission's own judgment as to the capital needs of the company.

As I understand the claim of ineligibility—and it is a claim that has come up in other jurisdictions—there are two important points to make here: the difference betwen California and other jurisdictions, and the reason why California is unique. This whole problem arose because the public service commission—and I listened to the witnesses carefully—said that the telephone companies in California were imprudent in failing to elect a tax benefit prior to the 1969 change in the tax law that mandated normalization as a ratemaking technique. If the company elected the tax deduction prior to 1969, the commission would have had the option of flowing through the benefit to ratepayers.

All of the Supreme Court cases in California stem from that basic finding, that basic conclusion of fact. This hadn't happened in other jurisdictions, and that is why California is distinguishable. Other companies, in fact, took the prudent course and elected the acceleration when they could under the tax law, prior to 1969.

This leads into the second point, and that is, what is this conflict over eligibility? The companies raise it as an attempt to force the commissions to abdicate their own judgment about the level of rates needed to support proper capital formation. In the tax code, the primary consideration is normalization for ratemaking purposes. As I understand it, the company has practically exhausted its appeals in its attempt to prove that the California technique fails to meet the standards of the Internal Revenue Code, that it is not normalization and therefore they would be ineligible.

The reason why they would run that appeal is because instead of being able three-quarters of the amount of booked deferred taxes, they want to keep 100 percent, and that is why they would fight it.

So, really that claim for ineligibility, it appears, has just about run out of gas. And that is, I believe, why the witnesses have expressed their opinion that in all likelihood the company ultimately will be found to be eligible.

Now, the second claim that if the company is allowed to collect this interest free capital—and this is a technical point, but it is important—should they reflect that in the capital determination that the ratepayers must pay a return on in the rates, that is the issue of rate base deduction. If the company has a source of interest free capital, shouldn't the ratepayers be given credit for it? And that is really what it appears that their substantive claim hangs on—that they might lose eligibility. And there doesn't appear to be any basis in the tax code for that claim in two controversy by the California companies.

So, this appears to be a problem that is more illusory than real.

The heart of my objection to H.R. 229 is how it would help preempt State utility commissions in an area that is the heart of ratemaking authority. The public service commissions across the country are charged with setting just and reasonable rates based on record evidence. And the issue herein involves a determination by a commission of the proper level of Federal income tax to be recovered in rates, and it involves millions of dollars per utility.

The ratemaking question is whether or not Federal income taxes collected in rates will be inflated; that is, the Federal income tax expense allowed in rates will be inflated to permit the collection of taxes that are, in fact, not paid during the ratemaking test year.

Mr. DANIELSON. In fact, what?

Mr. LEDERER. Not paid. That is what the conflict is all about. And the utilities want the commissions to allow them to collect on taxes that they haven't paid—that are booked as deferred taxes. And this legislation would help take that judgment away from the commissions, so the commissions would be forced to allow rates, even though they may decide that the rates are unreasonable and unjust, because they are allowing the collection of capital that the company does not, in fact, need to meet its public service requirements.

Mr. DANIELSON. Let me interject a question. You are in what to me is a very thick thicket. I'm having a hard time following you, not that you're not doing it well, but I don't have the commensurate understanding.

Are you saying here that under the tax benefit eligibility that we're talking about, accelerated depreciation and the like, the Revenue Code allows a certain percentage to be taken as the deduction if it is to be used for capital purposes?

Mr. LEDERER. Yes.

Mr. DANIELSON. But let's just say arbitrarily, that $100 million is set off. The utility doesn't need $100 million this year. They need some expansion, but they can do their expansion for $50 million, which means that having taken $100 million which the law allows them to take, they've got $50 million of capital reserves set up that they haven't used, but they will be able to use at some other time perhaps that——

Mr. LEDERER. That is what I'm addressing.

Mr. HARRIS. Will the gentleman yield on that point, then?

Mr. DANIELSON. Yes.

Mr. HARRIS. Just one other point on that. I think the utility companies, as long as they've got that capital, enjoy using it in the base for a return, which can then be reflected in the rate.

Mr. DANIELSON. In other words, they can earn interest on it, for example?

Mr. HARRIS. Also, the rate they charge their customer can reflect that capital accumulation as a return on the capital. Is that not correct?

Mr. LEDERER. Yes.

Mr. HARRIS. You have to understand that the basic thrust of the utility company is to show as much capital as possible, whether that is through expansion or through this way. It doesn't make any difference to them, because the bigger the capital, the more the rate base, the more income that they receive through rates.

Mr. DANIELSON. I've got that. The new element that came on in my mind a while ago was that the utility may collect—I'm using arbitrary figures—$100 million as a tax benefit but really only needs $50 million, so it has got an accumulation. It has got a capital formation of $50 million sitting here that they don't need yet but which is part of the rate base that as the gentleman from Virginia says—and likewise it is a source of income that could be put to work for them, and then a question. Should that capital structure be utilized as part of the

rate base in determining the return on capital? And second, how about the earnings on it? Is that what you're saying?

Mr. LEDERER. Yes, sir. And that is the heart of what a public service commission does—is make that kind of determination in trying to determine what are reasonable rates.

Mr. DANIELSON. We have been speculating here on changes in the Internal Revenue Code. Suppose that the Revenue Code provided for eligibility for tax benefits of not to exceed, say, 10 percent, but that the taxpayer could claim only the amount that they actually utilize. In my hypothetical, then, they could only claim the $50 million, and the other $50 million would not be available to them.

Would that, in part, solve your problem?

Mr. LEDERER. It would very much tighten it up, because it would tie the question of how much they could recover in the rates to what they actually needed. Yes, sir.

Mr. DANIELSON. And, of course, it would eliminate the interest-free capital totally because it would not be there.

Thank you. Go ahead. I appreciate your answers.

Mr. LEDERER. I think we have already addressed the subject that the amounts of money are not trivial. And I was just going to add that in a rate case that we discussed here in the District of Columbia that we litigated last year, that the full tax normalization was probably the largest single cash-flow item or one of the largest that the utility had on their cash-flow books.

Just to reiterate the point that we made——

Mr. DANIELSON. We are using this term "normalization" very often, and I think we all have some kind of concept. I'm frightened to tell you my concept, because it may be totally wrong. For the record, could you tell us what we're talking about by "normalization?"

Mr. LEDERER. Yes, sir. What it is, is the difference between the taxes that the company actually paid and those it actually recorded on the company books. And the difference arises because of tax deductions such as accelerated depreciation, so that what the company will do is record on their books straight-line depreciation, but for tax purposes they will record accelerated depreciation. And it will create the difference in taxes they will call deferred taxes.

And they call them deferred taxes because they assume that somewhere at the end of the life of the asset that they have taken accelerated depreciation on, they will have to end up paying the same total amount of taxes that they paid on straight-line depreciation, but the timing is different.

Mr. DANIELSON. In other words, years ago and maybe it's still true, there was something called a 5–4–3–2–1 depreciation.

Mr. LEDERER. Yes; that would be an accelerated type of depreciation.

Mr. DANIELSON. But to normalize that, you would for the normalization purposes spread it out uniformly straight-line over, let's say, 10 years?

Mr. LEDERER. That is what they do on their company books. They choose to do that for financial reporting purposes. So the normalization—what the normalization is is that when you get into setting rates—have I lost you?

Mr. DANIELSON. No, you haven't lost me. I've got the point.

Mr. LEDERER. When you set rates, you allow the company to collect the taxes on their books as opposed to the taxes that they pay.

Mr. DANIELSON. You have illustrated why we shouldn't interfere with ratemaking at all. It isn't our business. But I do feel that taxpayers—I remember I used to get an instruction to the jury that nobody is obligated to pay one penny more in taxes than the law absolutely requires. You have a right to try to minimize your taxes. You absolutely have a right to try to minimize them, so I can't blame the telephone company for trying to stay within the law, but yet utilize the provisions of the law as best they can.

A person who doesn't do that is just missing the boat, because that is what you're supposed to do. But there should be a way to resolve these problems without just going on forever and forever and forever. And that is what is worrying me here.

Mr. LEDERER. Mr. Chairman, I think the point that is to be made is that the California situation has proved unique. And I think that is what the city attorneys stated, because the whole California experience arose from the finding by the commission that the company has imprudent in not taking certain tax benefits, for example, as you yourself stated, not taking advantage of all of the tax savings that they could take prior to 1969. That was the finding of the commission, and the whole California case stems from that. Whereas in other jurisdictions, that problem never arose. That is one of the reasons why in the 10 years since we've had the 1969 Tax Act in effect we haven't had this problem anywhere else.

We don't have it in the District of Columbia. To my knowledge we, don't have it in Maryland or Virginia or Ohio or any of the states that I'm familiar with through my contacts with other public counsels.

Mr. DANIELSON. Why don't you have it?

Mr. LEDERER. We don't have it, because the companies have generally acted prudently and taking the tax benefits when the tax benefits were allowed.

And the whole California problem arose because the company did not take advantage of tax saving devices that could have saved not only in taxes to them but in rates to the ratepayers in the years prior to the 1969 Tax Act. That is how this whole controversy got started, as I understand it, and I look at the cases, and I've listened to the testimony carefully, and in other jurisdictions—and that includes the District of Columbia—the companies were all on flow-through—the electric company in the District of Columbia—took all of these deductions until, in fact, a couple of years ago. And then when they went the other way, they have been able to succeed in persuading the commission to give them this tax normalization.

In most of the public utilities around the country, they have done this. So that this uncertainty that we witness arising with the two telephone companies in California has not arisen in the other States, precisely because the other companies took advantage of the tax laws as they existed at the time.

Mr. DANIELSON. Thank you, and I won't interrupt you again. You go ahead with your statement.

Mr. LEDERER. I hope that clarifies that question.

Now I wanted to just quickly address what I saw as two possible constitutional problems. One is that the legislation may result in an unconstitutional intrusion on the sovereign authority of a State to decide what accounting or ratemaking procedures best serve the needs

of its citizens. That is a 10th amendment type problem. But it relates to what I testified to earlier concerning the preemption of the authority of the public service commissions.

The second problem has to do with the elimination as of this moment in the legislation of intervenor standing. Now I know it has been discussed, but what I wanted to say is that the ratepayer—and why it is probably a constitutional issue—the ratepayer is a party to every rate proceeding and has a strong justifiable interest in the outcome. Any declaratory judgment would not only affect the Federal tax liability of a company but also would ultimately affect rates.

Such a party is necessary if not an indispensable party to a ratemaking proceeding. If the ratepayer is denied an opportunity to present an argument in a declaratory judgment proceeding ultimately affecting rates, it very well could constitute deprivation of property without due process.

Finally, in my view, the real purpose of the legislation from the utility perspective is a part of a process—and I emphasize process—to prevent a public service commission generally, because it is not a narrow legislation—it would apply nationally—from making a judgment as to the level of capital needed by a utility, which we discussed already, and whether the commission ought to permit the compulsory collection of interest-free capital from the ratepayer to the utility, and if so, how much.

Now, this is an issue that is coming up with not only telephone utilities but gas utilities, electric utilities, and we've run into a problem here in the District of Columbia. In this jurisdiction, based on the capital formation plans of a local public utility, they plan for annual rate increases every year for the next 8 years, simply to support an increase in their capital investment of a very substantial amount which their own forecasts show they can't afford.

So this type of declaratory judgment would make it very difficult for the D.C. Public Service Commission to say to the company, "You can't do this."

So not only would this legislation help deprive the private Public Service Commission of the authority to make a crucial judgment necessary for determining just and reasonable rates, but it also may force the Public Service Commission to approve rates which may be inflationary.

Finally, the consequences of an ability by a public utility to force rates containing tax normalization are these: First, it could encourage unnecessary construction by removing economic barriers of capital acquisition which would normally inhibit nonesential construction; second, it would fail to stimulate a competitive marketplace for maney and do nothing to hold down interest rates because the utilities have a subsidy for raising capital; and third, the management of the companies would not be under any pressure to efficiently manage their capital expenditures. And I think as technical as this legislation has been, these other issues are also at stake. And I thank the committee for its time.

Mr. DANIELSON. Thank you, sir.

Mr. Harris of Virginia?

Mr. HARRIS. I want to take the opportunity to commend Brian for taking the time to come up here. I know how busy your office is. I

think that you have underscored the wisdom of this Congress in establishing home rule and creating the office which you currently serve in. The contribution, Mr. Chairman, that Mr. Lederer has made in regard to local utility rate matters has been enormous.

Mr. DANIELSON. Would the gentleman move up closer to the microphone. I think everyone should hear his words.

Mr. HARRIS. We have it written out, Mr. Chairman. We will pass out copies. [Laughter.]

But I do feel that the office and the function that you have served has been extremely important. I think your testimony today has been valuable to me and to the subcommittee as far as putting the problem into the proper perspective.

The question really isn't some vague question on taxes. The question is whether the utility company should be permitted to accumulate capital without need which inflate its rate base in such a possibly unnecessary manner.

I think the utility company has the responsibility to manage their financial affairs in such a way so as to properly protect the ratepayers through the proper utilization of tax laws. If, for any reason, they didn't do that, I think management is at fault and not the ratepayer.

And for that reason, I think it is extremely important for us to understand that when we intrude into that ratemaking procedure with artificial recourse to the courts, the delay in the return of rate payments to the consumers, where they emanated from, and where they should be returned, is a matter of great concern to me.

I'm not sure I understood that that well before your testimony, but I understand it now. And I appreciate your time you've given us.

Mr. LEDERER. Thank you, Mr. Harris.

Mr. DANIELSON. Mr. Hughes of New Jersey?

Mr. HUGHES. Thank you, Mr. Chairman.

I think that my colleague from Virginia has eloquently stated my own concerns in one aspect of the overall problem. And I think all of the testimony indicates to date that the California experience is unique and that I think there was some suggestion that one other State may have had a problem—Maine, I believe, but that was resolved. So, that indeed, California is the only State in the country apparently that has this particular problem.

And my only question really at this point is, what, if any, modification to the Internal Revenue do you think is warranted? Obviously, you are vehemently opposed to H.R. 229 in any form. You did suggest, however, that there is some question in interpretation of the Internal Revenue Code of 1954 as is amended, and my only question is, do you think that at this point it is proper subject for the Congress to get into?

Mr. LEDERER. Yes, Mr. Hughes, I do. I think it would deal with the California controversy. What I think Congress ought to address is, remove the mandatory nature of the rate treatment that the commissions must give if the companies elect these various deductions, the investment tax credit, the accelerated depreciation, and so forth, so that the commission can decide what is the proper level of rates to stimulate capital formation and not be in a position where it has to approve rates that are inflationary.

And then by removing that mandatory aspect of normalization in the tax laws, it would bring Federal anti-inflation policy and Federal tax

policy into consistency, which they are now in conflict. And it would have the byproduct of eliminating this eligibility problem.

Mr. HUGHES. And in essence give the commission more flexibility.

Mr. LEDERER. Yes. And I think all commissions are aware that rates have to be just and reasonable, and the constitutional standard for that is they must be sufficient to allow a company to attract capital at reasonable rates and to maintain the confidence of the financial community and the financial integrity of the company, so that the financial well-being of the company is protected by the very essence of rate making in any event.

And so what we have is Federal tax policy that is forcing the commissions to grant rates that are more than necessary to be just and reasonable.

I might add as a comment—I mean I notice that Mr. Dalenberg referred to financial problems that might arise over the tax liability from the financial community, because they could not float some equity issuance. Well, as I understand the way that the financial community reacts to rates is they want to know, are they just and reasonable, and will they give a sufficient return. I haven't heard anything or seen anything in the testimony by the representatives of the California telephone companies that the California commission has failed in that responsibility.

Maybe their financial problem in Wall Street has to do with the problems with interest rates. But in any event, that one amendment to the tax law would help.

Mr. HUGHES. I understand. I think you have addressed my own question very well. Thank you.

Mr. DANIELSON. Thank you.

We have tried, Mr. Lederer, in connection with this bill, to get the word out to all interested parties, which obviously includes the State regulatory commissions, that there is a bill pending, so that they will have an opportunity to appear, if they wish, and to be heard. I think we have done a fairly good job of it.

Do you know of anything, any area in which we have failed to notify the public? We have had letters from a number of people. Is there any area that we have left uncovered, so far as you know?

Mr. LEDERER. I think, Mr. Chairman, the word has certainly gone out about this bill. I know when I heard about it I communicated to my colleagues, the other public counsels. I sent a copy of the legislation and my testimony. So I think what I want to commend the committee on is holding this followup hearing, because that did give time for the word to get out and more people to have an opportunity to address the subject.

You may very well be receiving some further communications from the other public counsels by way of written letters.

Mr. DANIELSON. I imagine we will continue to hear from them for a while.

I want to take a different tack on the scope of the proposed bill. There has been a good deal of testimony here that the intervenors, as we now think of them, should be considered as necessary parties, if not indispensable parties. Suppose we went the other way and, since the declaratory judgment is intended to result in a definitive statement on the taxpayer's liability under the Internal Revenue Code, suppose

we went the other way and restricted it to the taxpayer and the Internal Revenue Service?

We wouldn't be impacting the regulatory commissions directly that way at all.

Would you comment on that approach? I have this in mind: The idea being to determine what is the meaning of the tax law insofar as the taxpayer is concerned.

Mr. LEDERER. Mr. Chairman, I think if you had a genuine issue of eligibility, which I do not believe in fact exists—at least, the company has not been all that clear on it. I do not believe that it would still address the problem of the ratepayer interest in the outcome of that eligibility determination so long as you have connected to that eligibility determination the ratemaking normalization requirements in the tax law.

Mr. DANIELSON. Are you quarreling with the normalization requirement? Are you criticizing it? Do you feel that that is an error in our tax laws?

Mr. LEDERER. I do, Mr. Chairman. You see, the eligibility problem turns around the ratemaking treatment by the commissions, and what they have done with these deferred taxes that you talked about earlier, that arise when the companies invoke the authority of accelerated depreciation and so forth to the Internal Revenue Code.

The eligibility question, I repeat, arises by the very essence of a disagreement over how the commission has handled the ratemaking aspects of the company's tax claims, which is caused by the normalization. Therefore, even if you eliminated the commission as a party, the ratepayer still has an interest in the outcome, unless you remove the ratemaking treatment as a mandatory aspect of the Internal Revenue Code.

Mr. DANIELSON. I see. So you would have to include the regulatory commission?

Mr. LEDERER. Yes, sir, and the ratepayer.

Mr. DANIELSON. I have no further questions. Thank you very much, sir. We appreciate your help. And if you have any additional ideas, you, as all other witnesses, are invited to submit them to us.

Mr. LEDERER. I thank you very much, Mr. Chairman.

Mr. DANIELSON. We have one additional witness, Mr. Robert Dalenberg, vice president and general counsel of Pacific Telephone. Mr. Dalenberg was kind enough to appear at an earlier meeting, and has also been kind enough to supply us with some information we then requested. And sir, you are back and we are glad to see you, and you may proceed at will.

[The complete statement follows:]

SUMMARY OF SUPPLEMENTAL STATEMENT OF ROBERT V. R. DALENBERG, PACIFIC TELEPHONE & TELEGRAPH CO. IN SUPPORT OF H.R. 229

The Pacific Telephone and Telegraph Company has begun to experience the adverse consequences of the inability to determine the effect on tax eligibility of the California Public Utilities Commission's September 1977 order. Additionally, on July 31, 1979, the California Commission issued another rate order embracing the same methodology as the 1977 order which further adversely impacts the company.

We strongly support H.R. 229. When enacted, H.R. 229 will provide a direct and narrowly focused method of resolving the federal tax dispute. Moreover, H.R. 229 provides a procedure to be used in all states so that public utilities can avoid the very serious problems now being experienced by Pacific Telephone in California.

I wonld like to thank you for permitting me to supplement and thereby bring up to date the testimony that I gave on August 2, 1979.

Events have moved on since that time, and the developments emphasize the need to provide a prompt remedy such as that in H.R. 229.

When I was here in August, I mentioned that The Pacific Telephone Company had filed with the United States Supreme Court for a stay of the decision of the California Commission which the Internal Revenue Service has ruled places in jeopardy Pacific Telephone's eligibility to use accelerated depreciation and to claim the investment tax credit for federal income tax purposes.

The Federal District Court had held that Pacific "met the requirements for injunctive relief" and has shown it will sustain irreparable injury if the California Commission's ratemaking methods retroactively destroyed eligibility to claim accelerated depreciation and the investment tax credit. But the court held it could not grant relief because of the doctrine of res judicata. The Court of Appeals affirmed but did not disturb the lower court's findings. We filed a formal petition for certiorari on August 10, and it is pending.

Mr. Justice Rehnquist first issued a temporary stay; however, on August 13 he dissolved the stay. Mr. Justice Rehnquist pointed out what he viewed as "the anomalous nature of the matter" in that

"* * * the questions which applicants seek to have reviewed on certiorari pertain to the application of federal tax statutes as they relate to depreciation which may be claimed by public utilities. Since it is this type of question which applicants seek to litigate if certiorari is granted, one would likewise expect either an agency or officer of the United States having some responsibility for administering these tax statutes named as respondents, instead of the California PUC or intervening California municipal corporations." (Slip op. p. 3-2)

H.R. 229 is designed to avoid the "anomalous" difficulties involved in bringing the state and federal governments to a uniform understanding and application of Sections 46 and 167 of the Internal Revenue Code.

Under existing law those difficulties are enormous. When we appealed the California rate decision, our opponents argued that the problem of federal tax eligibility and the meaning of the federal tax law were not issues in the case. The courts did not grant review. When we then sought to have the federal courts directly examine the matter, the same opponents successfully argued that the prior failure to review the case was res judicata and precluded a federal court examination of the federal tax law. Thus we find ourselves with no remedy that will bind both the state and the federal government.

H.R. 229 is needed to permit a prompt, clear, and binding determination. Waiting for audit and subsequent litigation exclusively with the Internal Revenue Service is not an adequate remedy because of the adverse effect the waiting period has on the financial position of the utility, as well as the consequent impact on the public, and the fact that the regulator is not a party to the proceeding. A court may by declaratory judgment deal with the eligibility question for all of the tax years covered by the ratemaking, in a timely manner, while the litigation following an Internal Revenue Service audit will only cover a year at a time. This is a sifinificant difference if there is to be adequate judicial guidance as to adjustments that must be made to reestablish eligibility after any period of its loss. Moreover, the tax audit normally raises many issues. H.R. 229 is limited to the single eligibility issue and thus will be simpler and faster. And, of course, H.R. 229 is designed to provide a remedy before, not after, the irreparable injury is done.

When Justice Rehnquist dissolved the stay order, it became necessary for Pacific to file tariffs with the Commission which effectuated the rate reductions and refunds ordered by the questionable decision of September 19, 1977. The Commission has not approved the refund plan and the rates selected for reduction but is expected to do so very shortly. Additionally, on July 31, 1979, the Commission rendered another decision in which it indicated that it will again embrace the ratemaking methodology of the September 1977 decision which, as I have mentioned, the Internal Revenue Service has ruled will destroy Pacific's eligibility for the tax benefits. The July 1979 decision directed a further reduction of some $42 million in Pacific's rates. We have asked for a rehearing, but do not yet know what disposition will be made of that motion.

These matters have been severe blows to Pacific. This has been reflected most clearly in the reaction of the financial community. In June of this year we had embarked upon the sale to the public of ten million shares of common stock. Last week we were advised by the proposed lead underwriter that Pacific should not go forward with its effort to sell common stock. The Board of Directors was forced to defer the sale indefinitely. This was based upon an assessment of the

market's reaction to the financial effects attendant upon Pacific's loss of the federal tax eligibility and the rate reductions imposed by the California Commission. We now find ourselves in a position where we may be unable to finance needed telephone service in the State of California.

The tax eligibility problem is not limited to a few utilities. Most utilities face the problem of maintaining an eligible position as to accelerated depreciation or investment tax credit, or both. While the proper normalization and ratable flowthrough methodologies are well known, departures from the proper methods have been intentionally sought or mistakenly embraced in California, Maine and Ohio. Other state commissions either intentionally or inadvertently will enter rate orders which place in jeopardy utilities' eligibility for accelerated depreciation and the investment tax credit. When that happens, only a procedure like that provided in H.R. 229 will avoid the consequences my company is now experiencing in California.

The assistance to utilities provided by the tax incentives of accelerated depreciation and the investment tax credit are large and very important. It is equally important that the certainty of their availability or their loss be clearly and promptly established. The problem cries out for a remedy that will permit a most expeditious means of resolving these tax eligibility questions in a manner that binds both the state regulator and the federal tax collector.

TESTIMONY OF ROBERT V. R. DALENBERG, VICE PRESIDENT AND GENERAL COUNSEL, PACIFIC TELEPHONE & TELEGRAPH CO.

Mr. DALENBERG. I appreciate being here again, Mr. Chairman. I have a formal statement and I would ask that that be submitted for the record.

Mr. DANIELSON. Without objection, that will be included in full in the record.

Mr. DALENBERG. And then there were two things I thought I ought to address before I forget them.

The first is, I think the preceding people have mentioned the decision by the Maine Supreme Court that came down a few weeks ago. In that decision, the Maine court—I think the first time any court has directly dealt with the normalization provisions of the Internal Revenue Code—the court found the reasoning in the Internal Revenue Service rulings that were issued for Pacific, which apparently were brought to their attention in that litigation, to be correct reasoning.

I don't think any of the parties have provided the committee with a copy of that decision, and I'm sorry I don't have a full copy with me. But I would like to, if I may, send your counsel a copy of that Maine decision.

Mr. DANIELSON. We could obtain it.

Mr. DALENBERG. I'm not sure it's out in the advance sheets.

Mr. DANIELSON. Counsel has just handed me a decision dated August 13, 1979, by Justice Rehnquist.

Mr. DALENBERG. No; I'm talking about the Maine Supreme Court and not the U.S. Supreme Court, and it involved the Central Maine Power Co.

Mr. DANIELSON. If you would send it, I would appreciate it.

Mr. DALENBERG. The court construed the normalization provisions as requiring just that, and reversed a decision of the Maine commission that had required a partial flowthrough. And Mr. Chairman, I must admit, for a fleeting moment only I thought that maybe I would prefer to live in Maine rather than California.

Mr. DANIELSON. I know that would be a fleeting moment.

Go head, sir.

Mr. DALENBERG. The second thing I might mention is a question that I think Mr. Pines sort of left for me, and that is, how does the

Pacific Telephone Co., and I think the telephone companies in general, handle this reserve. When a company computes its deferred taxes, it then creates on its books a reserve for the future payment of those taxes. And that amount is shown on its books as a liability account. That ultimately is paid off to the Internal Revenue Service.

Now, that reserve is not left in the form of cash. The dollars that have come to the company by following the normalization methodology are promptly invested in capital equipment to serve the ratepayers. And in California, where we have currently a capital construction budget of somewhat over $2 billion a year, the $250 million or so that we get each year out of both the accelerated depreciation deferral and the investment tax credit only offsets a portion of our need for capital equipment and for additional capital in each year.

So that the reserve itself, while it appears on the books of the company, is not available should you suddenly, years later, be told that that deferral of taxes was impermissibly done and you must now currently pay the taxes. And in that regard, I think we should keep in mind that there is a very distinct difference between rate repayments and payment of taxes to the Internal Revenue Service. And I'm sure Mr. Agnost was not trying to mislead the committee when he indicated that Pacific had stated to the California courts that it could pay the refunds.

We have always told the California courts we could pay the rate refunds. By the same token, we have always told everybody that if we are ineligible for the tax benefits, the payment of—the repayment of the taxes by Pacific over this extended period, this more than $1 billion that we face now, will be a severe thing for the company, which will impact us severely.

And of course, it is that kind of contingent liability to which I refer in my updated testimony, that apparently is having a bad effect on our ability to finance the company. That kind of liability, which is coming on as a very current thing as the Internal Revenue Service moves to collect it, was one of the factors that caused us not to be able to sell our common stock, and is a factor that may create serious difficulty for us in continued financing of this enormous capital need that we have in California of well over $2 billion of new plant each year.

Now, that is a unique figure. I'm not sure that any private company in the United States other than Pacific faces that kind of need.

Rather than summarize what I have written you, I thought possibly I might simply comment on one or two of the other points of the possible amendments to the statute that you have before you.

So far as other parties coming into a declaratory judgment proceeding, there's no doubt that the Treasury is correct, that the more parties you have into a lawsuit, the slower it goes. Under the present law, I would suggest to you that this question is entirely solved. The district judge has discretion to permit intervention or to keep intervenors out, depending upon whether he can see if they will be of assistance.

The district judge in the Federal lawsuit that we have brought in this particular matter that is causing us trouble permitted the cities that appeared before you today to intervene. He also excluded one individual ratepayer who sought intervention, who apparently the judge thought would not contribute to the case.

So far as permitting each and every party to a rate case to have an independent cause of action to bring a declaratory judgment proceed-

ing, I would think that would be unwise. There are virtually no standing rules in California as to who may intervene in a rate case. I think every ratepayer virtually has a right to come into a rate case. And to permit everybody to bring declaratory judgments over the tax liability of each and every utility would not seem to me to be a solution to the kind of problem that we have, whereas to permit a simple declaratory judgment proceeding as to a particular order of a particular commission, either by the commission that put in that order or by the utility who is directly affected by that order, would provide an answer to a question that under today's methodology has to wait for 5, 6, or more years, while this unfortunate liability that certainly the Congress doesn't like to see us shoulder keeps accruing.

I think, beyond that, we think that the statute as drafted would solve a problem. There is no doubt that the rest of the Nation has been watching California and that that may have some effect on reducing how that problem—how often that problem has popped up. But I think you have to keep in mind that virtually every utility that I know of—I think most utilities in the United States are faced with an eligibility problem, either as to accelerated depreciation or as to the investment tax credit.

The Congressional Record indicates that when the 1969 Tax Reform Act was adopted, that roughly half of the States were on normalization and roughly half were using flow-through. Now, every one of the utilities that were on normalization has had to continue that way. Others have been permitted to elect to shift that way. And therefore they all, in each rate case, have the normalization issue before them.

Congress in 1971, when it adopted the investment tax credit, really adopted the thesis of the normalization method of accounting, by providing for the ratable flow-through method under option 2 of that tax benefit. And it repeated that action in 1975, when it increased the investment tax credit.

Now, it is policy determinations in those three statutes that I would support. I think they were wise policy determinations. But there is no question that the utilities who are relying upon those determinations have received their rates in accordance with them and can be exposed to very large liabilities, either if a commission intentionally seeks to walk too far near the line or if it simply makes a mistake. The problem with things as they now stand is that you can't test it until you have been hurt, and the injury is great. The injury hurts not only the utility; it will hurt the ratepayers and the general community.

If we are forced to pay back, as Mr. Halperin indicated, as much as $3 billion by the time this litigation is over, it is going to severely injure all of California. If it severely injuries all of California because our telephone system is hurt by that, that telephone system is an integral part of the U.S. telephone system. The whole Nation will see it.

Providing for a quick way to resolve this kind of thing is distinctly in the public interest. And I would just say again that support the bill. We support it and think that we need it as quickly as we can possibly get it.

Thank you.

Mr. DANIELSON. Thank you.

Mr. Harris?

Mr. HARRIS. Thank you, Mr. Chairman. I would limit my questions to quick ones, just basically.

There is a thesis of utility law, as I understand it, that State and public utility commossions make determinations with respect to adequate capital accumulation and whether or not it is excessive or deficient. And I thought I heard you saying that the California PUC was inadequate in that regard, that they did not permit you adequate capital accumulation.

Mr. DALENBERG. No, I did not intend to say that. What I suggested was that our capital needs currently are over $2 billion. I think we are at about $2.3 or $2.4 billion for this year. And that the capital that we are able to generate internally won't, of course, anywhere near accomplish that. The open capital markets are pressed and probably can't accomplish it for us. And we close the gap with the aid of this particular help from the Federal Government.

Now, the California commission, in the decision that we have all been talking about but nobody has really mentioned to you distinctly, the commission said clearly and squarely that it wanted to retain eligibility because the benefits of that eligibility were so great and so important, not only to Pacific but to the community in general.

Mr. HARRIS. I don't think you would have any argument with regard to eligibility. I want you to retain eligibility, too. But I have a great fear that somehow the Federal Government, whether it is through the Tax Code or some other method, might be taking over the function of the State utility commissions. You wouldn't like that to happen, would you?

Mr. DALENBERG. No; we're not advocating that.

Mr. HARRIS. But on the other hand, the requirement for normalization does take over a particular part of that function.

Mr. DALENBERG. It leaves it to the commission to do it or not do it. The very difficult problem is a commission that says, we are doing it right, we want you to have it, but does it wrong. If the California commission said to us, we do not want you to participate in the Federal program and we will make your rates with knowledge that you are not, we would have very little problem with that. We would go out and work as hard as we could to generate the capital.

Now, I don't think that we could accomplish it without a very, very substantial rate increase. You must realize that this Federal program permits our rates to be very substantially reduced from what they would be if the program did not exist.

Mr. HARRIS. I don't think there's any question about that. I just have, as I say, a notion that through a Tax Code we direct the public utility commission to act in a particular way. Do you really feel it is improper, if you get into a matter like this, to assure that the ratepayer has standing in such an action?

Mr. DALENBERG. I think the ratepayer is cleanly and clearly and totally represented by the commission.

Mr. HARRIS. In some cases, and in some cases not.

Mr. DALENBERG. I think that is the commission's job. It's their duty. It's what the statute says they're supposed to do. They have arrived at their decision.

Mr. HARRIS. Sometimes they are just appointed political hacks, though, aren't they?

Mr. DALENBERG. I have never used that term.

Mr. HARRIS. But isn't that true?

Mr. DALENBERG. No; I don't think so.

Mr. HARRIS. This is why you need judicial review, isn't it?

Mr. DALENBERG. You need judicial review because people make mistakes.

Mr. HARRIS. Thank you, Mr. Chairman.

Mr. DANIELSON. I don't know what in the world a political hack is. Maybe they have them in Virginia.

Mr. HARRIS. That is a member of the other party, Mr. Chairman. [Laughter.]

Mr. DANIELSON. Mr. Hughes of New Jersey?

Mr. HUGHES. Thank you, Mr. Chairman.

It is my understanding in the history of this case that Pacific did not feel that its accounting methods entitled them to eligibility.

Mr. DALENBERG. Pacific's own accounting methods are quite proper. The accounting method adopted by the commission in its September 17, 1977, decision probably will not retain eligibility. And in appealing that decision, we have squarely argued that it is inconsistent with the eligibility provisions.

Mr. HUGHES. So in essence, you have felt that you are not entitled to eligibility. Then in that *Pleasure* decision, the California Supreme Court determined that you were in error.

Mr. DALENBERG. The California Supreme Court did not review the case.

Mr. HUGHES. Then the public utility commission decided you were eligible?

Mr. DALENBERG. There's no question about that. The public utility commission said eligibility should be preserved; and, second, that their action preserves it. And that is where the conflict arises.

Mr. HUGHES. The point has been made here, and I thought made fairly well, that under the circumstances it is felt that—at least the city attorneys who appeared here felt—that under the circumstances, that Pacific was a lukewarm advocate of its entitlement to continued eligibility. And the concern has been expressed that perhaps if we set up a separate procedure, such as the declaratory judgment procedure, that perhaps there wouldn't be the advocacy that we have seen to date on this and other issues.

What do you have to say about that argument?

Mr. DALENBERG. I would like to comment upon that. The first thing, I doubt if I could ever convince them as to our order in any particular respect.

Mr. HUGHES. Do you concede that you might have been in error, that you are entitled to continued eligibility, that the PUC is correct?

Mr. DALENBERG. In my own personal opinion, no. I think that they made a mistake. But let me give you the complete comment.

Mr. HUGHES. Let me just take it one step further and then you can respond to all of them. Then if that is the case, I have to assume that you feel that the utility should avail itself of accelerated depreciation and investment tax credit; and if indeed the utility feels that way, why isn't the utility trying to get a clarification of the Internal Revenue Code, since ultimately that should be the final answer? Maybe you can address all of those points.

Mr. DALENBERG. First of all, I think it is a mistake. I'm afraid that I'm supported in that by the only people who have written about it.

There has been a law review article in the Stanford Law Review that reviews this whole thing. It came out saying the attempt by the commission was an "evasion"—that is the word they used—of the Internal Revenue regulations.

The Rutgers Law Review wrote an article about it, and the author—I do not know the author—came to the same conclusion, that the action by the Commission will result in our loss of eligibility. The Internal Revenue Service in its rulings came to that result. The Solicitor General, when he apeared before the Supreme Court and advocated that the Court look at our case, confirmed that that would be the result. The Department of Justice appeared in the ninth circuit just a few months ago and filed a brief saying that was the result.

They all are telling me that my opinion is correct. Now, when we went to the Internal Revenue Service and asked for a ruling, we were faced with the situation that we, as lawyers, were appealing a commission decision which we believed was inconsistent with the Federal tax law, and where we were to assert to the appellate courts that it was inconsistent with the tax law.

And the Internal Revenue Service rules required that counsel who seeks the ruling state his view as to what he thinks the outcome must be. I think all of us have found ourselves in two courts where we felt the requirement on the basis of our professional need to be very square with that second court as to the position we had taken in the first, which we did here and which they have alluded to you, and is the basis of their feeling of our lukewarmness, which I can understand.

But at the same time we did that, I filed a motion with the commission in which I asked that the commission direct its staff to present to the Internal Revenue Service in connection with our ruling request, their position and their arguments as to why their decision is good. And the cities were invited by General Telephone to do the same thing and General had the same ruling going the same way. They declined. They refused to do it.

Indeed, the California commission entered an order which said that if, in fact, it turns out that you are ineligible we will penalize you more. They didn't go to the IRS then. I don't know why they are here saying to you that you should amend this H.R. 229 to permit them to enter into the same thing in the future. And that is the full story on the question that you asked.

Now, I'm not sure that I remembered the other issues you raised.

Mr. HUGHES. Working on the assumption that you feel that Pacific—and General, I assume is in the same category—should avail itself of the investment finance credit and accelerated depreciation, why, if there is some question as to the question of eligibility, haven't you pursued it by trying to get a clarification of the interpretation, and a modification if need be of the 1954 tax code?

Mr. DALENBERG. What I understand you're saying to me is that the California Commission has now imposed a partial flowthrough and what we should do is come back to Congress and ask them to change the 1969, 1971, and 1975 acts to legitimize a partial flowthrough which was specifically what Congress in those acts said it didn't want to do.

Mr. HUGHES. Don't we have a partial passthrough in other States beside California?

Mr. DALENBERG. It depends entirely, if I remember this law correctly, on whether you were on flowthrough accounting prior to Au-

gust 1, 1969, and if you were not on flowthrough prior to that date, Congress set it with a retroactive date. Then, in all other States they are either on normalization or you must take straight line accounting. It was not true—as I think was indicated here—that everybody else was on flowthrough. I don't think that's the case at all.

Mr. HUGHES. I don't think anybody suggested that everybody is on flowthrough but obviously the California experience on flowthrough is not unique in itself. As far as I understand it there are other States that do permit some flowthrough. Apparently the problem comes in because there is now some question as to whether or not the normalization procedure that is mandated prevents California, which apparently is unique with its particular rate order, is denied eligibility. And my question is, if that is indeed the issue, why wouldn't it be a much preferable approach to get a clarification or modification of the statute? Why is that not the preferable route to trying to create an entirely new procedure which ultimately will only decide that issue? Apparently there must be more that you envision will be decided by declaratory judgments than just this issue in the future.

Mr. DALENBERG. Well, I guess my opinion is that Congress, in deciding what the basic and proper policy is with respect to this kind of tax cut, will retain what I think is an appropriate long-term policy, which is to generally require the normalization method of accounting. That normalization accounting is required for all nonregulated enterprises.

If you have got an unregulated business, you have to use normalization accounting. That's all there is to it. And I think Congress is going to retain that and I think the chance of legitimizing this flowthrough by coming back to Congress for something different—first, they would conclude it is unwise and therefore there is very little chance, so that there will be normalization requirements in the future, and as long as there are normalization requirements, then you have a need to try to bring prompt certainty into the situation, which is what H.R. 229 does.

Mr. HUGHES. Then if indeed it is the policy of the Congress to make normalization the public policy, then don't we still have certainty? Isn't that what we are seeking, if indeed what we are trying to determine is what was the public policy in the 1969 amendments? If that is what we're trying to decide, rather than approach it from an oblique point of view—that is, set up an entirely separate procedure, and a declaratory judgment procedure with all of the problems and pitfalls that that encompasses, wouldn't it be much preferable to get a pronouncement from the Federal Government as to what is the law, whether it be in favor of the PUC or whether it be, in fact, supporting the original decision?

Mr. DALENBERG. I really don't know what you are suggesting. I think the law is on the books.

Mr. HUGHES. Yes; but it doesn't address this particular issue, apparently.

Mr. DALENBERG. That this be a resolution of Congress that say whether California's commission is right or wrong?

Mr. HUGHES. There's been some suggestion, and I haven't examined the technical language, that in the report language in 1969 that there was some suggestion as to how this procedure would be implemented.

We often find that confusion creeps in through the history that we write in connection with legislation. We often leave wide gaps. Often the Internal Revenue Service in implementing legislation provides, through the regulatory process, regulations that really do not carry out the intent of the Congress, and it may very well be that we haven't made it very clear. Obviously, there's a great deal of confusion because it is now in litigation and the issue will ultimately be decided, perhaps, by some court if this declaratory judgment relief is not provided through the normal course of appeal.

And my question is, if in fact we have a question of tax laws, and if there is so much at stake, why aren't you approaching it from that vantage point also? Why just put all of your apples in one basket, that is a declaratory judgment ruling to try to approach this particular narrow issue?

Mr. DALENBERG. I don't think anybody has seriously thought that that question existed. I think that the little piece of legislative history that was quoted here was taken badly out of context, and that anyone, including all those people I've just related to you who has read that legislative history, has made it clear that that little piece would be out of context, and that question that you are suggesting as to whether there has been a proper rate base deduction, really isn't much of a question.

I think the problem is an ongoing problem of, how do you promptly resolves the anomalous treatment of what could be clearly treated. There is no question, Mr. Halperin was right, that the safe road is well understood by all of the commissions.

It is the commissions that want to get an over to the exact line or beyond, that creates severe problems. And the problem is really most severe because of this time lag, that when the commission order comes down you have to wait 5, 6, 7 years before you can litigate it in the IRS in the ordinary fashion. That is the real key problem, and unless you totally eliminate what has proved to be a very valuable Federal program in the sense of the accelerated depreciation program and the investment tax credit, unless you totally eliminate that so nobody is going to ever have to deal with it, that issue will continue.

Mr. HUGHES. I'm not so sure anybody has suggested that we eliminate that, but there has been some suggestion that perhaps the commission should have a little more flexibility in determining in the normalization procedure just what is a fair and reasonable and proper rate. And the conflict with the Internal Revenue Code, perhaps, can be relieved by giving some additional flexibility to the public utility commissions.

But even if that weren't the case, there is some legitimate question of interpretation—and apparently there is. We had three attorneys that testified here earlier, city attorneys. We have had others that have testified who are fairly responsible witnesses, you also have testified that there is some question of interpretation. And that being the case, wouldn't it be far more preferable to try to address the confusion and the question of interpretation by Congress? Doesn't that provide the certainty that you are looking for?

Mr. DALENBURG. The confusion they expressed to you is one I'm not able to concur in, in that I have not been able to find in either the legislative history or the statute—if there is something out there that they

feel needs to be addressed, I think I would echo your request. Let them write it down. I haven't seen it.

Mr. HUGHES. I have to assume that the public utility commission is a responsible agency and they have responsible advice. They have interpreted the statute differently than you have, obviously.

Mr. DALENBURG. They have?

Mr. HUGHES. Are you suggesting to me that this is not a fair and responsible interpretation?

Mr. DALENBURG. Yes.

Mr. HARRIS. Would the gentleman yield on that?

Mr. HUGHES. Yes.

Mr. HARRIS. I think this is exactly the thicket the subcommittee gets into when it considers this legislation. The public utility is vested with this responsibility in the State. We've got the Federal boys right into the position they should not be in and that is regulating utilities in individual States and usurping the sovereign rights of California.

Mr. HUGHES. I could not agree with my colleague more. I think that is exactly what this does. And I thank the chairman.

Mr. DANIELSON. I have a couple of questions here, to follow up.

As I understand it, maybe I am oversimplifying but as I understand it, what you are seeking is a method of obtaining a definitive ruling on what the law means, apropos of whether you are entitled to certain tax benefits or are not entitled to them.

Mr. DALENBERG. That's absolutely correct.

Mr. DANIELSON. I don't think this bill addresses your form of accounting directly. You are going to probably have to adjust your form of accounting once you determine what is the application of the tax law to you. But as I see it, what you are seeking when you ask us to consider this legislation, is a method of resolving precisely what is the impact of the Internal Revenue Code upon your company apropos these two or three items we are discussing; isn't that about all it amounts to?

Mr. DALENBERG. That is the total of it.

Mr. DANIELSON. If you could get that definitive statement from the Internal Revenue Service promptly, you would be satisfied with that, I assume?

Mr. DALENBERG. In whatever manner will bind the three parties, ourselves and the two sovereigns who disagree.

Mr. DANIELSON. The State, the Federal Government and yourselves?

Mr. DALENBERG. Yes.

Mr. DANIELSON. We're doing a lot of talking about accounting here, and the like, and it is all relevant to a degree. But I see this bill only as calling for the providing of a method of having a definitive ruling on the meaning of certain provisions of the tax law.

Now, I recall—and I'm happy that the gentleman who is with Mr. Halperin is still in the room—I think I recall Mr. Halperin making a suggestion to the effect that if such a law as this were to be passed, maybe that the jurisdiction should be vested in the Tax Court rather than the district court, inasmuch as the Tax Court has a greater expertise in tax matters.

Sir, you are back there. Am I pretty close to home on that statement?

Mr. RABINOVITZ. Yes, Mr. Chairman. The only change I would make is we would like to see it extended to the Tax Court, not necessarily vested exclusively in the Tax Court.

Mr. DANIELSON. I see that, both the Tax Court and the district court share jurisdiction?

Mr. RABINOVITZ. Yes.

Mr. DANIELSON. Thank you. One other question, the subject of tax-free capital formation has been discussed in talking with one of the witnesses, Mr. Lederer. I brought up the hypothetical situation that a company might be eligible for $100 million but only utilize $50 million, and thereby accumulate another $50 million as a capital reserve, which is sort of a tax-free status.

Does that situation apply to Pacific Telephone in the matter before us?

Mr. DALENBERG. No; as I indicated, we have never been in a capital surplus position. We never have had a capital surplus. We are worried about a capital deficit position rather than a surplus.

Mr. DANIELSON. I think you have responded—no, it was in your affirmative statement, you made a statement to the effect that your annual capital outlay is around $2 billion, $2.3, I think you said.

Mr. DALENBERG. I think that is it, currently.

Mr. DANIELSON. And that the tax benefits which would be generated by the law we are talking about are more in the neighborhood of $250 million?

Mr. DALENBERG. Yes, the actual figures were in my original testimony here, and I think that's about right.

Mr. DANIELSON. But that is a ballpark figure.

Mr. DALENBERG. That's right.

Mr. DANIELSON. So your capital outlay per annum is running eight to nine times greater than the tax benefits you would derive from these provisions of the Internal Revenue Code.

Mr. DALENBERG. Yes.

Mr. DANIELSON. You could not then be acquiring tax-free capital reserve very well under this interpretation?

Mr. DALENBERG. Well, not the kind of example that you use.

Mr. DANIELSON. Well, do you have it under any example?

Mr. DALENBERG. No; in fact, I don't know—I thought about that when you mentioned it before. I'm not quite sure how mathematically that could ever work out for any company. Maybe there is some way.

Mr. DANIELSON. I'm not a good enough accountant to carry that in mind anyway, but I just wanted to get those facts straight. I am concerned here, and this is probably as much a comment to my fellows as anybody, this case has dragged on for many, many years. Meanwhile, your company is building up a potential tax liability which gets greater each year. Our other witnesses have assured us that there is an overwhelming probability that you will be held eligible for the tax write-off and therefore not have to pay an accumulated tax obligation.

Are you sure you will not have to pay that obligation?

Mr. DALENBERG. Well, I don't think any lawyer could look at you and say he is 100 percent sure one way or the other. As I expressed, my own opinion is that they made a mistake and that we are going to pay for that mistake, and that all of these outside people, independent, who have an ax to grind, they have all concurred in that up to now. And I have not heard any good rationale on how we are going to avoid paying those taxes.

Mr. DANIELSON. You have not yet paid them?

Mr. DALENBERG. No, sir.

Mr. DANIELSON. You have on your books a deferred tax liability of reserve set up?

Mr. DALENBERG. That is correct. In our published financials, the accountants show that as a tax liability, period, because under their rules it can no longer be termed a deferral.

Mr. DANIELSON. What is the size of that, now?

Mr. DALENBERG. $1 billion.

Mr. DANIELSON. How much——

Mr. DALENBERG. $1 billion.

Mr. DANIELSON. Would that be in principal or is that including interest?

Mr. DALENBERG. I think that includes roughly the interest, but again, the specific dollars were in my original testimony.

Mr. DANIELSON. That money is not sitting there as cash, but it has been invested and you simply acknowledge it by the book entry?

Mr. DALENBERG. That's correct.

Mr. DANIELSON. What impact does this have on your ability to sell stock in Pacific Telephone or whatever other means of financing you have?

Mr. DALENBERG. It is quite apparent that a company where this large an amount is likely to be a current liability, has a substantially lower credit status than a company that does not.

Mr. DANIELSON. Well, has it impacted you?

Mr. DALENBERG. Yes, it has. It has cost us more for our borrowing. As I said, we have recently had to defer the sale of common stock on the advice of the underwriters, and as we look forward, we believe we are going to have serious difficulties in any form of additional capital for the future.

Mr. HARRIS. Would the gentleman yield?

Mr. DANIELSON. Surely.

Mr. HARRIS. What is the capitalization of the company?

Mr. DALENBERG. The intrastate capitalization, the portion subject to regulation by the California Public Utilities Commission, I think is around $6 billion, 6 or 7.

Mr. HARRIS. How about the rest?

Mr. DALENBERG. I would have to take a look in here. We are up to about $8 or $10 billion total.

Mr. HARRIS. And you feel like this $1 billion potential liability affects your credit rating that much?

Mr. DALENBERG. Yes, sir.

Mr. DANIELSON. I believe you've answered all of the questions I have, sir.

Mr. HUGHES. I have an additional one.

Mr. DANIELSON. Go ahead.

Mr. HUGHES. Why, at this point, wouldn't the normal procedure of deficiency assessment, notice of deficiency which presumably will be going out in the near future—because, as I understand it, the 1974 audit is just about completed—and an appeal to the Tax Court be a lot faster than waiting for this legislation to be passed?

Mr. DALENBERG. It would be. I think at this point——

Mr. HUGHES. So how is this going to help your situation? I don't understand it.

Mr. DALENBERG. Well, as I said before when I was here, I was not at all sure that it could help with respect to the 1977 order. Now the

commission, in July of this year, entered another order which indicated that it will go again to this methodology. It could conceivably help with that. The audit and deficiency procedure will get our 1974 year before the tax court within a matter of some months, I suppose, but it is not going to help with the 1978.

Mr. HUGHES. Well, I suppose it is a matter of public policy, as whether you want to encourage continued applications to a tax court or Federal district court, where utilities or others decide that they want to try to keep it as close to the line as possible. There are many ways in which you can, I'm sure, set up your books and you can be safe and follow the rules and regulations and the code or you can stretch it and try to keep it as close to the line as you want.

And so, what you're saying in essence is we would set up a procedure where a company—not that you would—could perhaps stretch the law as much as you can to minimize the tax and if you are wrong, can always go in and get a declaratory judgment. I mean, isn't that going to precipitate a great deal of additional filings before the Federal district court?

Mr. HARRIS. I would not think so.

Mr. HUGHES. Well, I find that people, as my distinguished chairman said, don't always want to pay more than they have to. And that's the way that it should be. I agree with that. I just regret that we individuals don't have such things as deferred taxes that we can schedule and things like that.

But I just worry whether or not that wouldn't be one side——

Mr. DALENBERG. I don't think there's any question that if you provide a remedy such as this there will be some more litigation than there is today without a remedy. But I don't think there is going to be a deluge of remedy, nor do I think that you'll find that utilities undertake to squeeze themselves as far to the line as possible.

Mr. HUGHES. Well, there is such a thing as safe accounting practices and procedures that follow normal procedures. And then there are the pioneers, and human nature is just ingenious in trying to find ways to try to avoid paying taxes. And I suspect that if indeed we are not helping the California situation with this legislation—and that apparently is the case—I wonder as a matter of public policy whether setting up a declaratory judgment mechanism is good from the standpoint of engendering additional litigation.

Mr. DALENBERG. I guess I would submit that the pioneers are out there. And they're going to be out there pioneering whether or not we have H.R. 229, and that H.R. 229 is going to help those of us who are caught between pioneers.

Mr. HUGHES. Thank you. Well put.

Mr. DANIELSON. I again would make one comment. I am distressed here the taxpayers have to go on so many years for a definitive ruling. That is what bothers me. I think that the utilities should pay the taxes they are obligated to pay. I think individuals should pay the taxes they are obligated to pay. Everyone should. But it does something to me to find that the Government, which has the right to collect the taxes, can delay interminably, year after year after year after year, in coming up with a decision that people must use in order to determine the course of conduct that they have to follow.

I think, if anything, no matter what happens on this bill, one spin-off effect may be that the Revenue Service will move a little bit faster—if it moves at all, it will be moving faster. So I think that that could be an effect.

Mr. HUGHES. Mr. Chairman, I don't think the Internal Revenue Service has really caused this—even though I agree with you quite often they take a great deal of time in deciding what we thing are at times very simple issues. In this situation the tremendous delay has not been by the Internal Revenue Service.

Mr. DANIELSON. Well, you know I sometimes——

Mr. HUGHES. I think that's the first time I've ever defended the Internal Revenue Service. But I don't think in this instance they have been the cause of the delay, and I can't believe that the commissioner, recognizing how important this is, not just to Pacific and General, the utilities, but to all the citizens of California, can't make a timely decision on the issue, and that the tax court, if indeed an appeal is filed, can't expeditiously handle a case of this magnitude.

Mr. DANIELSON. May I ask the gentleman this: How long has this matter been brought into the official cognizance of the Internal Revenue Service?

Mr. DALENBERG. Well, we—in 1970, I think we asked them for a ruling as to what normalization was, and provided that to the commission, but I think that this order—you see, the first definitive thing that would jeopardize eligibility was the 1977 order of the commission.

Mr. HUGHES. The public utility commission.

Mr. DALENBERG. Yes. And we of course applied for the ruling shortly after that came out.

Mr. DANIELSON. When would that have been, more or less? I know you don't have the precise date.

Mr. DALENBERG. November or December 1977. They ruled about 6 months or so later, the following June or July, I think they ruled. And as I understand it, their audit procedure, which catches the 1974 year and completes it about now, is their normal procedure, and that maybe it has been speeded up a little bit because they recognize the nature of our problem.

Mr. DANIELSON. Well, I just hope——

Mr. DALENBERG. It is the auditing that is the problem.

Mr. DANIELSON. I can't see that there would be any need to even consider this bill which we have been considering, because it appears there may be a remedy like it. If there were a more efficient way of coming up with a definitive answer to these questions—I hate to put this added burden on the district courts, Every time I talk to the Judicial Conference they complain about their workload. We created 152 new judges in the last year. There won't be that many cases, but I just hate to put the burden on there, but maybe we don't have any choice.

I think you, Mr. Dalenberg, for your help. At the opening of this meeting I stated that I thought this would be the last taking of testimony. And maybe it will, but I don't want to close the hearings yet. It could be that in the next few days there will be some others who will contact us and who will have something to contribute. So we will keep it open temporarily.

I do have, while the committee is still here—that will be the end of the testimony for today, however, and I thank each and all of you for your help. While the committee is still here, since the last meeting I have had some communications which I would like to put in the record without objection.

First of all, a letter from the California Public Utilties Commission affirming that Mark D. Chandler, who appeared before us before, even though he is not an employee of that commission, was appearing with their authorization and he did officially speak for them.

Second, a letter from Pacific Telephone by Mr. Dalenberg, dated August 29, 1979, submitting some proposed amendments to the bill.

Third, another letter from the Public Utilities Commission of the State of California dated June 22, 1979, stating some objections to H.R. 229.

A letter from Public Service Commission of the State of West Virginia, dated August 9, 1979, stating objections to the bill and proposed amendments should the bill be adopted despite those objections.

A letter from Idaho Public Utilities Commission dated July 31, 1979, commenting on H.R. 229 and making several suggestions.

A letter from Tennessee Public Service Commission, August 15, 1979, directed to Joel Rabinovitz of the Office of Assistant Secretary of the Treasury, a copy of which came to us, commenting also on H.R. 229.

A letter from Pennsylvania Public Utility Commission dated July 30, 1979, commenting on H.R. 229 and generally speaking opposing it.

A letter from Oklahoma Corporation Commission dated August 2, 1979, on the bill H.R. 229 and opposing it.

A letter from State of Michigan Department of Commerce dated July 23, 1979, a copy of which was furnished to us, directed to Mr. Rabinovitz, of the Office of the Assistant Secretary for Tax Policy of the Department of Treasury, opposing the bill H.R. 229.

And last, a letter from the National Association of Regulatory Utility Commissioners, dated August 30, 1979, on H.R. 229 stating that—or transmitting a resolution supporting the enactment of H.R. 229, but suggesting an amendment.

Without objection, these will be received into the record. And there is no such objection.

[The documents follow:]

PUBLIC UTILITIES COMMISSION,
STATE OF CALIFORNIA,
August 2, 1979.

Congressman GEORGE E. DANIELSON,
Chairman, Subcommittee on Administrative Law and Government Relations, Committee on the Judiciary, House of Representatives, Washington, D.C.

DEAR CONGRESSMAN DANIELSON: In your subcommittee this morning testimony was presented on H.R. 229. I understand that questions were raised concerning the authority and responsibility of Mr. Mark D. Chandler to appear on behalf of the California Public Utilities Commission.

The Commission appeared pursuant to your letter request of June 29, 1979. Please be advised that Mr. Chandler was authorized by the Commission to appear on its behalf and that his presentation was approved by the Commission.

We remain available to work with your subcommittee to reach an effective solution to the problems addressed by H.R. 229.

Very truly yours,

JOHN E. BRYSON, *President.*

PACIFIC TELEPHONE,
San Francisco, Calif., August 29, 1979.

Hon. GEORGE E. DANIELSON,
Chairman, Subcommittee on Administrative Law and Governmental Relations,
House Judiciary Committee,
Washington, D.C.

DEAR CHAIRMAN DANIELSON: At the conclusion of the Subcommittee's hearing on H.R. 229 on August 2, 1979, you solicited further comments and recommendations of the parties who had appeared at that hearing. There are two specific matters I would like to address.

1. Some concern has been expressed that H.R. 229 as presently drafted might be construed to create a general federal appeal from state ratemaking orders. In order to avoid any such implication the first sentence of Section 2202 could be revised to read as follows:

"(a) A court shall issue a declaratory judgment, as provided in Section 2201, in a case of actual controversy between a public utility and either the Secretary of the Treasury or a ratemaking body, with respect to the effect of an order of the ratemaking body on the public utility's eligibility under the provisions of section 46(f), 167 (*l*) or 167(m) of the Internal Revenue Code of 1954."

2. There was a suggestion that every party to the ratemaking proceedings should be an essential party to the declaratory judgment action and, in addition, any of those parties should be able to initiate a declaratory judgment suit with respect to the utility's tax problem. Such suggestion is unwise and should not be adopted. H.R. 229 is not designed to create a general federal appeal procedure from state ratemaking orders. If it were, the participation of all parties to the rate case might be appropriate. Instead H.R. 229 creates a procedure for the early determination of a specific issue of the utility's individual tax liability under the Internal Revenue Code. As H.R. 229 recognizes, this involves a dispute between a public utility and either the Internal Revenue Service or the state regulatory agency. Other parties to the state ratemaking proceedings are neither necessary nor appropriate to this federal income tax determination. The other parties are able to advance their individual interests as to rate matters before the state agency in the ratemaking proceedings. In addition, under present law the District Judge would have discretion to permit intervention by other parties, but such intervention should not be required since the addition of parties will necessarily slow down the proceedings. The matter should be left to the District Judge's discretion.

Thank you for the opportunity to testify before your Subcommittee on August 2 and to provide these further comments and recommendations.

Very truly yours,

R. V. R. DALENBERG,
Vice President and General Counsel.

PUBLIC UTILITIES COMMISSION,
STATE OF CALIFORNIA,
June 22, 1979.

Re H.R. 229.

GEORGE E. DANIELSON,
Chairman, House Judiciary Committee, Subcommittee on Administrative Law and Government Relations, U.S. House of Representatives, Washington, D.C.

DEAR CHAIRMAN DANIELSON: The Bell Telephone System is sponsoring legislation (H.R. 229) that would permit actions to be brought in Federal court seeking declaratory judgments with respect to certain provisions of the Internal Revenue Code (Sections 46(f), 167(l), and 167(m)). The Declaratory Judgment Act (28 U.S.C. 2201) now prohibits such actions with respect to Federal income tax matters.

The Public Utilities Commisison supports the concept of providing for an early determination of significant questions regarding Federal income tax matters. An early determination would be in the interests of both utilities and ratepayers. While we have several specific objections to H.R. 229 as presently drafted, we would look forward to working with your committee to reach an acceptable solution.

The Commission's main objections at this time are:

First, H.R. 229 does not limit declaratory judgments to questions relating strictly to the tax implications of Sections 46 and 167. Federal courts could also assert control over public utility ratemaking decisions, traditionally an area of state jurisdiction and concern with respect to intrastate utility operations.

Second, the bill provides that only the affected public utility or regulatory agency may seek a declaratory judgment. There are normally other interested parties in ratemaking proceedings before this Commission, such as large cities, consumer groups and representatives of various other classes of customers. We believe that the bill is deficient in not including such interested parties within its ambit.

Third, H.R. 229 is limited to questions arising under Sections 46(f) and 167(l) and (m). No reason for such a limitation appears. If the bill has merit, it should not be limited so narrowly. Conversely, the very fact of the limitation suggests that it is special legislation without any valid purpose that would outweigh the potential problems raised.

Fourth, it is important that H.R. 229 not provide for a stay of a regulatory agency proceeding or decision pending conclusion of an action for declaratory judgment. This would permit unacceptable interference with state proceedings and orderly procedures. Such interference would be contrary to the Federal policy against interference with or interruption of state regulatory rate-making proceedings embodied in the Johnson Act, 28 U.S.C. 1342.

We reiterate our hope to work with your committee to reach an effective solution to the problems addressed by H.R. 229.

Very truly yours,

JOHN E. BRYSON, *President.*

STATE OF WEST VIRGINIA,
PUBLIC SERVICE COMMISSION,
Charleston, August 9, 1979.

Re H.R. 229, a bill proposing to amend title 28, United States Code, to provide for a declaratory judgement in certain cases involving public utilities.

Mr. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Washington, D.C.

DEAR MR. RABINOVITZ: The West Virginia Public Service Commission wishes to make known its position with regard to the above-referenced bill.

The Commission is opposed to the enactment of this bill for the following reasons:

The bill would allow Federal courts to dictate to state regulatory agencies in the area of Federal tax questions, resulting in a weakening of the regulatory authority of these bodies.

The bill would allow Federal courts to enjoin, suspend or restrain the operation of rate making orders issued by state regulatory agencies. Again, this would weaken the regulatory authority of these bodies, and is contrary to Federal policies against interference with such proceedings.

We believe the bill should be rejected completely. However, if it is enacted, we recommend that the following modifications be made:

If enacted, the bill should limit declaratory judgements to tax questions. In its current form, the bill would permit the courts to establish the rate making impact of such questions.

If enacted, the bill should provide that all parties involved in an action be included in the procedure seeking a declaratory judgement. In its current form, the bill allows only the affected utility or regulatory agency to seek a declaratory judgement.

If enacted, the bill should be prospective in its scope.

It should not be applied to issues currently being considered by state regulatory agencies.

If you require any further clarification of our position on this matter, please feel free to contact us.

Sincerely,

E. DANDRIDGE MCDONALD,
Chairman, Public Service Commission of West Virginia.

IDAHO PUBLIC UTILITIES COMMISSION,
Boise, Idaho, July 31, 1979.

Re H.R. 229—A bill proposing to amend Title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

Hon. GEORGE F. DAVIDSON,
Chairman, Subcommittee on Administrative Law and Governmental Relations, U.S. House of Representatives, Washington, D.C.

DEAR MR. DAVIDSON: The Idaho Public Utilities Commission submits the following comments on the above-referenced bill:

1. The bill should be limited strictly to the interpretation of tax statutes, and not expanded to other areas which have a direct impact on tax liabilities; i.e., depreciation lives for income tax purposes versus depreciation lives for ratemaking purposes.

2. If the bill is enacted, a pleading for Declaratory Judgment should not be limited to the public utility or the ratemaking body. All intervenors in a particular rate case should be eligible to file a pleading for a Declaratory Judgment.

3. A.T. & T.'s proposed Stay Amendment, when a Declaratory Judgment is sought, should be rejected, since this would seriously interfere with the implementation of Commission orders.

In conclusion, the Idaho Public Utilities Commission respectfully requests that the Subcommittee on Administrative Law and Governmental Relations give serious consideration to the above comments regarding H.R. 229.

Respectfully submitted,

MYRNA J. WALTERS,
Commission Secretary.

TENNESSEE PUBLIC SERVICE COMMISSION,
Nashville, Tenn., August 15, 1979.

In re H.R. 229, a bill proposing to amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

Mr. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Washington, D.C.

DEAR MR. RABINOVITZ: The Tennessee Public Service Commission is opposed to H.R. 229 because it would have serious implications on our regulation of ratemaking authorities, particularly in telephone proceedings regarding accelerated tax issues. The bill as written does not limit declaratory judgment to tax questions. The rate-making impact could also be established by the Federal courts, and if H.R. 229 is enacted it should be specifically amended so as to be limited to interpretation of tax statutes so as to not to erode the states' traditional jurisdiction over rate making.

Also, the bill as written provides only that the affected utility or regulatory agency may seek a declaratory judgment. It should also authorize action by all necessary parties and intervenors such as the various cities in Tennessee or consumer groups that participate in Commission proceedings. It is my understanding that the bill will be amended so as to provide for a stay while the declaratory judgment matter is pending in Federal court. A stay provision would thus authorize real interference for State proceedings and is contrary to the Federal policies against interference with such proceedings.

For the foregoing reasons this Commission is opposed to H.R. 229.

Sincerely yours,

Z. D. ATKINS, *Chairman.*

PENNSYLVANIA PUBLIC UTILITY COMMISSION,
Harrisburg, Pa., July 26, 1979.

Re H.R. 229.

Hon. PETER W. RODINO,
U.S. House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN RODINO: The Pennsylvania Public Utility Commission opposes the enactment of H.R. 229 for the following reasons:

(1) H.R. 229 would not accomplish the goal of providing a final interpretation of Federal tax law in time for use in a rate case. No "actual controversy" be-

tween a utility and the PUC can arise until the PUC issues its final order in a rate case, because the PUC considers the impact of the Internal Revenue Code in all cases in the process of reaching its final determination. The declaratory judgment action would therefore take place simultaneously with any state court appeal of the ratemaking order, and would almost certainly be decided too late for inclusion of its results in the appellate briefs. Even if the declaratory judgment were issued in time for oral argument in the state appellate court, a time-consuming and wasteful remand would be necessary if the judgment were contrary to the Commission's resolution of the issue.

Further delays inevitably would be caused if the utility did not already have a Revenue Ruling from the Department of the Treasury, and no such Ruling would be relevant unless based on the precise ratemaking decision issued by the PUC. Further delays would be caused by any appeal of the declaratory judgment to a Cricuit Court of Appeal and the U.S. Supreme Court. If the declaratory judgment action were not complete before the termination of state court appeals from the rate case, it could be too late to avoid losing the Investment Tax Credit, under Internal Revenue Code § 46(f)(4). Therefore, the declaratory judgment action would hinder rather than help the process of ratemaking.

(2) If it were timely, the declaratory judgment action would involve an unseemly controversy between the Treasury and a state regulatory agency in the Federal courts. If a declaratory judgment were timely and binding, it would control the manner in which a regulatory commission could account for the investment tax credit or liberalized depreciation. Whether the Commission's order did or did not fit within the guidelines of the Internal Revenue Code would be of no matter to the utility, because in the latter event, the order would have to be changed if it caused the loss of the investment tax credit or liberalized depreciation. Therefore, the utility would not likely be an aggressive litigator in the declaratory judgment proceeding. In effect, H.R. 229 would allow a utility to hale the Treasury and a Commission into Federal court. The two agencies would do battle, and the utility would collect its spoils from the winner. If the Commission won, the utility would be protected from a loss of tax benefits. If the Commission lost, it could not cause the utility to lose its favored tax situation without making appropriate adjustments.

(3) The declaratory judgment litigation might be reduplicated in the state appellate courts and in the U.S. Tax Court. If a Commission were to disagree with a declaratory judgment that a certain course of action would cause the loss of liberalized depreciation or the investment tax credit, nothing in H.R. 229 would prohibit it from proceeding with the course of action. Certainly the Federal court would not and could not attempt to write a state commission's intrastate ratemaking order. In such a case, no doubt the utility would appeal to the state courts, and no doubt the IRS would assess a tax deficiency. The issue would then be relitigated in the course of the appeal, and would be relitigated simultaneously in the Tax Court if the utility chose to challenge the IRS assessment. If the declaratory judgment turned on an issue of law rather than fact, the state appellate court and the U.S. Tax Court might well call for full briefing and argument on the issue. Full briefing and argument in the two courts would certainly occur if the declaratory judgment action were not completely finished, including all rights of appeal.

(4) H.R. 229 is in conflict with the basic policies of the Declaratory Judgment Act, which it would amend.

(a) H.R. 229 causes judicial interference with the orderly Federal tax collection process. Normally, taxes are assessed and collected on a basis of a past year's transaction. If a taxpayer is fearful about entering into a transaction without knowing the position of the IRS, it may seek a Revenue Ruling. Such a process is already contemplated under H.R. 229, which requires the application for a Ruling before any declaratory judgment suit. H.R. 229 goes beyond the Ruling and attempts to settle a tax question finally before a state regulatory commission's decision becomes final. The Commission and the Treasury would thus be required to litigate in a situation which would still be fluid, and might be required by a utility to litigate the tax issues in a single rate case several times. If the judgment were against the Commission's Order, the Order would be revised. The utility could then seek a new Revenue Ruling and a new declaratory judgment with respect to the new Order, if the utility were not completely satisfied with the new Order's propriety under the tax laws. This situation is directly contradictory to the purpose of the tax exception to the Declaratory Judgment Act:

Thus, the purpose of the tax exception to the Declaratory Judgment Act, like the Anti-Injunction Act, is to prevent the disruption which would occur to the federal revenue gathering processes if these processes were subject to judicial interference prior to the actual determination, assessment and collection of tax liabilities.

Dietrich v. *Alexander*, 427 F. Supp. 135, 137–138 (E.D. Pa. 1977).

(b) H.R. 229 provides an unnecessary federal forum for an issue which is and should be fully litigated in state courts, and would cause conflicts between Federal courts and state regulatory commissions and courts. If a utility is aggrieved with a commission's tax decision, it has full rights of appeal within the state's appellate court system. The proper allowance for Federal taxes is a matter of state law for intrastate utilities. Even though it involves the interpretation of Federal law, the amount of allowable expenses is essentially a state issue. The injection of a declaratory judgment into the state regulatory and appellate process would cause conflicts where none exist, and would require time-consuming remands to consider the Federal Court's decision. A Third Circuit Court of Appeals opinion, which cites and quotes from Fourth, Fifth, Sixth and Ninth Circuit Court opinions, makes it clear that such a situation is undesirable:

The granting of a declaratory judgment is discretionary and not mandatory. "Said discretion is to be exercised in accordance with sound judicial principles and the purposes of the Declaratory Judgment Act." One such judicial principle is the avoidance of needless conflict with a state's administration of its own affairs. A second is that litigation belongs in the court which is best suited to determine the controversy. "The object of the statute [the Federal Declaratory Judgment Act] is to afford a new form of relief where needed, not to furnish a new choice of tribunals or to draw into the Federal courts the adjudication of causes properly cognizable by courts of the states." "The . . . statute should not be used to secure a judgment which would impinge on a state proceeding and which might result in a conflict between the decisions of state and federal courts." The Act is not a substitute for an appeal from a state judgment, nor does it convey to a Federal court the power to review a state court decision. In the appropriate exercise of its discretion, a Federal court should deny declaratory relief under the same conditions wherein injunctive relief would be impermissible, e.g., where the result would be interference with and disruption of state court proceedings. "The statute should not be used to try a case piecemeal." A final factor is whether the granting of a declaratory judgment would result in increased congestion of the Federal courts.

Travelers Insurance Co. v. *Dallas*, 490 F. 2d 536, 543–544 (3d Cir. 1974) (footnotes and citations omitted).

All of the above factors apply to H.R. 229. It disrupts the states' ratemaking and appellate procedures; it draws Federal courts into a matter which is primarily a state issue; it causes possible Federal-state conflicts; it causes a piecemeal trial of a rate case; and it might increase congestion in Federal courts.

Even if the worst occurs, i.e. a state commission's ratemaking treatment causes a utility to lose a substantial tax benefit, the utility may always at that time seek redress before the state commission and state courts. The proposed legislation, with all its possible procedural and substantive problems, is therefore unnecessary and, worse, counterproductive.

Sincerely,

W. WILSON GOODE.

OKLAHOMA CORPORATION COMMISSION,
Oklahoma City, Okla., August 2, 1979.

Re H.R. 229—A bill proposing to amend Title 28 U.S. Code to provide for a declaratory judgment in certain cases involving public utilities.

Mr. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Washington, D.C.

DEAR MR. RABINOVITZ: It is our understanding that the captioned proposed legislation has been assigned to the House Judiciary Committee for study. The Oklahoma Corporation Commission has made an evaluation of the impact which this proposed legislation would have, and this Commission opposes enactment of this legislation for the reasons hereinafter stated.

An evaluation of H.R. 229 reveals that this bill, if enacted, would have serious implications with respect to public utility commission rate making authority. The language of H.R. 229 does not limit declaratory judgment to tax questions. Specifically Section 2202(A) of the proposed bill would authorize the courts to issue declaratory judgments in actual controversies with respect to rate making and its relationship to Sections 46(f), 167(1), or 167(m) of the Internal Revenue Code of 1954. Reasonable levels of taxes are often at issue in rate making proceedings, and this bill would permit federal courts to issue declaratory judgments interpreting federal tax questions as they relate to state rate making proceedings, thus, preempting the rate making authority of state public utility commissions. In addition the bill as written does not establish the scope of its effect. If enacted it should minimally provide for prospective application only.

American Telephone and Telegraph Company has proposed an amendment to H.R. 229 which would allow a stay of public utility commission proceedings pending resolutions of declaratory judgment issues taken to federal district court. A stay of public utility commission proceedings and the effect of any orders issued by public utility commissions would create a substantial hardship on customers served by utilities in that it would preclude rate adjustments from being ordered in a timely manner and would further result in actual interference with state proceedings, a result which is clearly contrary to federal policy as established in 28 U.S.C. Section 1342.

As a result of the impact which H.R. 229 would have both on public utility commissions in attempting to perform their responsibilities and on the rate payers whom we seek to protect, the Oklahoma Corporation Commission strongly urges your office to oppose passage of this proposed legislation.

By THE CORPORATION COMMISSION,
HAMP BAKER, *Chairman.*
BILL DAWSON, *Vice Chairman.*
NORMA EAGLETON, *Commissioner.*

STATE OF MICHIGAN,
DEPARTMENT OF COMMERCE,
July 23, 1979.

Mr. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Washington, D.C.

DEAR MR. RABINOVITZ: The Michigan Public Service Commission opposes the proposed Bill H.R. 229 which would amend Title 28 of the United States Code to provide for Declaratory Judgment in Certain Public Utilities, and the additional AT & T Amendments.

We feel that passage of such legislation would seriously undermine State regulatory authorities which would not serve the best interests of the ratepayers. The supporting rationale for our opposition is as follows:

1. The proposed legislation is quite ambiguous to the scope of the jurisdiction of the federal courts over the state regulatory Commission's ratemaking authority. Unless the bill is limited to the interpretation of tax status, serious in-roads on the traditional state jurisdiction are certain to occur.

2. Sections 46(f), 167(1) and 167(M) of the Internal Revenue Code of 1954 are the only sections of the Code that would me specifically subject to declaratory judgment jurisdiction under this bill. If the bill has any merit or valid purpose, it would not be so limited.

3. The proposed AT & T amendment (4) would allow a district court to enforce, suspend or restrain the operation of State Commission's ratemaking order when a declaratory judgment is sought. This would authorize real interference with our state rate-making authority, and is contradictory to the Federal policies against interference with such proceedings.

4. The bill should provide all "necessary" parties with authority to seek a declaratory judgment and should not limit such authority to only the affected utility or regulatory agency.

I hope that these comments will be given serious consideration in the formulation of the administrations position.

DANIEL J. DEMLOW, *Chairman.*

STATE OF CONNECTICUT,
DEPARTMENT OF BUSINESS REGULATION,
DIVISION OF PUBLIC UTILITIES CONTROL,
Hartford, Conn., July 30, 1979.

Mr. JOEL RABINOVITZ,
Office of the Assistant Secretary for Tax Policy,
U.S. Department of the Treasury,
Washington, D.C.

Re: H.R. 229, a bill proposing to amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

DEAR MR. RABINOVITZ: Because of the far-reaching potential consequences of the subject bill H.R. 229, the Connecticut Department of Business Regulation, Division of Public Utility Control, feels that it must take a position opposing this ruling.

Essentially the proposed bill could have serious implications on state regulatory commissioners' ratemaking authority. This is so because the bill does not limit declaratory judgment to tax questions and unless the bill is limited to interpretation of tax statutes, inroads on state jurisdiction are possible. We are of the opinion that to the extent the bill would interfere with he flexibility and independence of the various state commissions it is undesirable.

Sincerely,

JOHN T. DOWNEY, *Chairperson.*

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS,
Washington, D.C., August 30, 1979.

Re H.R. 229, a bill to amend title 29, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

To: The Members of the Subcommittee on Administrative Law and Governmental Relations of the House Committee on the Judiciary.

DEAR REPRESENTATIVE: The National Association of Regulatory Utility Commissioners (NARUC) deeply appreciated the opportunity to testify before your Subcommittee on August 2 concerning H.R. 229.

We indicated during the testimony that our Executive Committee would be meeting August 15–16, 1979, to consider H.R. 229 and other regulatory matters.

On August 16 the enclosed Resolution Re Declaratory Judgments Respecting Federal Income Taxes was adopted. The Resolution supports enactment of H.R. 229, if amended. 1. "to limit the operation of H.R. 229 to questions of interpretation of Federal tax statutes only and not questions of intrastate ratemaking; 2. to authorize other interested parties as well as utilities and regulatory agencies to seek declaratory judgments; 3. to provide for declaratory judgments under all provisions of the Internal Revenue Code; 4. to preclude any stays of a State regulatory agency proceeding or decision pending conclusion of an action for declaratory judgment, or a subsequent Federal action based on such declaratory judgment; and 5. to provide that such bill not constitute an abrogation or modification in any respect of the Johnson Act (28 U.S.C. 1342)."

We shall be pleased to work with the Subcommittee further on this legislation.

With warm best wishes, I am

Sincerely yours,

MARGO L. JAMES,
Director of Congressional Relations.

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS,
Washington, D.C., September 19, 1979.

Hon. GEORGE E. DANIELSON,
Chairman, Subcommittee on Administrative Law and Governmental Relations, Committee on the Judiciary, U.S. House of Representatives, Cannon Office Building, Washington, D.C.

Re: H.R. 229, a bill to amend title 29, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

DEAR MR. CHAIRMAN: Thank you for your recent letter on the above referenced bill in which you request our opinion as to who should "be included as proper parties to the declaratory judgment proceeding or what specific categories of

persons could qualify as parties," if the bill were amended to expand the number of persons eligible to initiate such proceeding.

In a Resolution Re Declaratory Judgments Respecting Federal Income Taxes, adopted August 16 by the NARUC Executive Committee, we supported an amendment to the bill which would "authorize other interested parties as well as utilities and regulatory agencies to seek declaratory judgments". We interpret this to give authority to seek the declaratory judgment to those persons who have standing under applicable State law to appear as parties in the State regulatory proceeding from which the declaratory judgment arises. I have attached as Appendix A to this letter the Resolution, which I request be inserted in the record of this legislation.

Also enclosed as Appendix B are letters regarding H.R. 229 from the following member commissions, which we request be inserted in the record as well: Connecticut Division of Public Utilities Control; Idaho Public Utilities Commisson; Pennsylvania Public Utility Commission; and Tennessee Public Service Commission.

It has been a pleasure to be of assistance to you. Should you desire additional information, please do not hesitate to contact us.

Sincerely yours,

MARGO L. JAMES,
Director of Congressional Relations.

Enclosures.

RESOLUTION RE DECLARATORY JUDGMENTS RESPECTING FEDERAL INCOME TAXES

Whereas, No court of the United States may by law issue a declaratory judgment with respect to Federal taxes, and H.R. 229 (96th Cong., 1st Session) would delete this provision of law with respect to declaratory judgments regarding Sections 46(f) and 167 (l) and (m) of the Internal Revenue Code; and

Whereas, H.R. 229 could provide for an early determination of significant Federal income tax questions and hence would be in the interests of both utilities and ratepayers; and

Whereas, H.R. 229, as introduced, first, does not limit declaratory judgments to interpretation of tax statutes only, but could apply to questions of intrastate ratemaking properly within an area of State jurisdiction; second, provides only that the affected public utility or regulatory agency may seek a declaratory judgment thereby omitting other interested parties representing various customer classes; third, is limited to the questions arising under Sections 46(f) and 167 (l) and (m) of the Internal Revenne Code only, thus excluding from its scope all other potential Federal tax questions; and, fourth, does not preclude the stay of a State regulatory proceeding pending conclusion of an action for declaratory jndgment or such a stay pending a further Federal action based on such declaratory jndgment pursnant to 28 U.S.C. 2202, either or both of which would permit unacceptable interference with State proceedings and orderly procedures and wonld be contrary to the Federal policy of non-interference with State regulatory proceedings embodied in the Johnson Act (28 U.S.C. 1342); now, therefore, be it

Resolved, that the Executive Committee of the National Association of Regulatory Utility Commissioners recommends that Congress favorably consider H.R. 229 (96th Congress, 1st Session) with appropriate modifications to limit the operation of H.R. 229 to questions of interpretation of Federal tax statutes only and not qnestions of intrastate ratemaking; to authorize other interested parties as well as utilities and regulatory agencies to seek declaratory judgments; to provide for declaratory judgments under all provisions of the Internal Revenue Code; to preclude any stays of a State regulatory agency proceeding or decision pending conclusion of an action for a declaratory judgment, or a subseqnent Federal action based on such declaratory judgment; and to provide that such bill not constitute an abrogation or modification in any respect of the Johnson Act (28 U.S.C. 1342).

Mr. DANIELSON. I have no further items before us today, and therefore the subcommittee will stand adjourned pending the call of the Chair.

[Whereupon, at 1:10 p.m., the hearing was adjourned, subject to the call of the Chair.]

APPENDIX

[The following material was subsequently submitted for inclusion in the record.]

COVINOTON & BURLING,
Washington, D.C., September 10, 1979.

Re: H.R. 229.

DANIEL I. HALPERIN, Esq.,
Deputy Assistant Secretary, Department of Treasury,
Washington, D.C.

DEAR MR. HALPERIN: In light of our conversation of last week, I have the following comments to offer on behalf of General Telephone & Electronics Corporation with regard to H.R. 229 which would create declaratory judgment jurisdiction for Section 46(f) and Section 167(*l*) controversies involving utilities, regulatory commissions and the IRS.

I. H.R. 229 WILL HAVE IMPORTANT APPLICATION TO THE PRESENT CALIFORNIA SITUATION

First, the California decision, even though court review appears to have been exhausted, has not yet been actually applied to reduce rates or cause refunds. If H.R. 229 were to become law today, the rate changes and refunds could be held off either by voluntary action of the Public Utilities Commission or by a stay order while the parties secure a declaration of the tax consequences of Decision No. 87838 without risking hundreds of millions of dollars of tax benefits now in jeopardy.

Even if H.R. 229 does not become law rapidly enough to accomplish directly the above effect, passage by the House of Representatives might encourage the Public Utilities Commission voluntarily to stay its order because of the tremendous advantages to the California ratepayers in eliminating the down-side risk of Decision No. 87838.

Even if H.R. 229 is enacted too late to protect the hundreds of millions of dollars involved in 1979 and earlier years, it will still offer a much faster and fairer route for judicial resolution of the controversy for the future. In normal Federal tax litigation, it is not possible to isolate out the Section 46(f) and Section 167(*l*) issues from other Federal income tax issues which are necessarily involved for the period in litigation. It takes time for both utilities and the IRS to resolve or litigate all other outstanding issues before there can be a decision on the depreciation and investment tax credit questions. In General's case, it will be several years before there can be a lower court decision deciding the Federal income tax effect of Decision No. 87838. Appeal and certiorari will undoubtedly add a couple more years to that period. Moreover, the Public Utilities Commission would not be a party to the tax litigation, though it will be bound by the decision in that litigation.

H.R. 229, by isolating immediately the Section 46(f) and Section 167(*l*) issues, will shorten the period of litigation by at least two years and at the same time give the Utilities Commission the right to participate.

II. ENACTMENT OF H.R. 220 WILL NOT CAUSE A FLOOD OF DECLARATORY JUDGMENT LITIOATION

No doubt some regulatory commission have refrained from following the California course because of the awesome potential loss of tax benefits involved. H.R 229 will remove this threat and allow a regulatory body to proceed on the California course without risking loss of tax benefits.

It is submitted that any increase in litigation will be small and temporary. Given the delay in rate cases and their sporadic nature, it is likely that there would be a definitive declaratory decision in the California case before most other states would have a chance to get very far down the path. Moreover, many states will be reluctant to create delay and uncertainty in their own rates in pursuit of such a long-shot will-o'-the-wisp. In any event, when there is a definitive decision in the California case, other states will not need to invoke the declaratory judgment procedure to find out what the law is.

If H.R. 229 does not provide the appropriate mechanism for prompt and fair court resolution of the California controversy, I am at a loss to understand what Treasury would accept in light of Deputy Assistant Secretary Sunley's March 28, 1979 testimony before the Oversight Subcommittee of the Committee on Ways and Means.

If there is any additional information which I can supply, please let me know.

Sincerely yours,

JOHN B. JONES, Jr.

IDAHO PUBLIC UTILITIES COMMISSION,
Boise, Idaho, July 31, 1979.

Re H.R. 229—A bill proposing to amend title 28, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

Hon. GEORGE F. DAVIDSON,
Chairman, Subcommittee on Administrative Law and Governmental Relations, House of Representatives, Washington D.C.

DEAR MR. DAVIDSON: The Idaho Public Utilities Commission submits the following comments on the above-referenced bill:

1. The bill should be limited strictly to the interpretation of tax statutes, and not expanded to other areas which have a direct impact on tax liabilities; i.e., depreciation lives for income tax purposes versus depreciation lives for ratemaking purposes.

2. If the bill is enacted, a pleading for Declaratory Judgment should not be limited to the public utility or the ratemaking body. All intervenors in a particular rate case should be eligible to file a pleading for a Declaratory Judgment.

3. A.T. & T.'s proposed Stay Amendment, when a Declaratory Judgment is sought, should be rejected, since this would seriously interfere with the implementation of Commission orders.

In conclusion, the Idaho Public Utilities Commission respectfully requests that the Subcommittee on Administrative Law and Governmental Relations give serious consideration to the above comments regarding H.R. 229.

Respectfully submitted.

MYRNA J. WALTERS,
Commission Secretary.

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS,
Washington, D.C. August 30, 1979.

Re H.R. 229, a bill to amend title 29, United States Code, to provide for a declaratory judgment in certain cases involving public utilities.

To the members of the Subcommittee on Administrative Law and Governmental Relations of the House Committee on the Judiciary:

DEAR REPRESENTATIVE: The National Association of Regulatory Utility Commissioners (NARUC) deeply appreciated the opportunity to testify before your Subcommittee on August 2 concerning H.R. 229.

We indicated during the testimony that our Executive Committee would be meeting August 15–16, 1979, to consider H.R. 229 and other regulatory matters.

On August 16 the enclosed Resolution Re Declaratory Judgments Respecting Federal Income Taxes was adopted. The Resolution supports enactment of H.R. 229, if amended "to limit the operation of H.R. 229 to questions of interpretation of Federal tax statutes only and not questions of intrastate ratemaking; to authorize other interested parties as well as utilities and regulatory agencies to seek declaratory judgments; to provide for declaratory judgments under all provisions of the Internal Revenue Code; to preclude any stays of a State regulatory judgment, or a subsequent Federal action based on such declaratory judgment; and to provide that such bill not constitute an abrogation or modification in any respect of the Johnson Act (28 U.S.C. 1342)."

We shall be pleased to work with the Subcommittee further on this legislation. With warm best wishes, I am

Sincerely yours,

MARGO L. JAMES,
Director of Congressional Relations.

Enclosure.

RESOLUTION RE DECLARATORY JUDGMENTS RESPECTING FEDERAL INCOME TAXES [1]

Whereas, No court of the United States may by law issue a declaratory judgment with respect to Federal taxes, and H.R. 229 (96th Congress, 1st session) would delete this provision of law with respect to declaratory judgments regarding Sections 46(f) and 167 (l) and (m) of the Internal Revenue Code; and

Whereas, H.R. 229 could provide for an early determination of significant Federal income tax questions and hence would be in the interests of both utilities and ratepayers; and

Whereas, H.R. 229, as introduced, first, does not limit declaratory judgments to interpretation of tax statutes only, but could apply to questions of intrastate ratemaking properly within an area of State jurisdiction; second, provides only that the affected public utility or regulatory agency may seek a declaratory judgment thereby omitting other interested parties representing various customer classes; third, is limited to the questions arising under Sections 46(f) and 167 (l) and (m) of the Internal Revenue Code only, thus excluding from its scope all other potential Federal tax questions; and, fourth, does not preclude the stay of a State regulatory proceeding pending conclusion of an action for declaratory judgment or such a stay pending a further Federal action based on such declaratory judgment pursuant to 28 U.S.C. 2202, either or both of which would permit unacceptable interference with State proceedings and orderly procedures and would be contrary to the Federal policy of non-interference with State regulatory proceedings embodied in the Johnson Act (28 U.S.C. 1342). Now, therefore, be it

Resolved, That the Executive Committee of the National Association of Regulatory Utility Commissioners recommends that Congress favorably consider H.R. 229 (96th Congress, 1st Session) with appropriate modifications to limit the operation of H.R. 229 to questions of interpretation of Federal tax statutes only and not questions of intrastate ratemaking; to authorize other interested parties as well as utilities and regulatory agencies to seek declaratory judgments; to provide for declaratory judgments under all provisions of the Internal Revenue Code; to preclude any stays of a State regulatory agency proceeding or decision pending conclusion of an action for a declaratory judgment, or a subsequent Federal action based on such declaratory judgment; and to provide that such bill not constitute an abrogation or modification in any respect of the Johnson Act (28 U.S.C. 1342).

NEED FOR DECLARATORY JUDGMENT LEGISLATION

PROBLEM

Congress has provided liberalized depreciation (accelerated methods of depreciation (accelerated methods of depreciation and shorter periods for depreciation) and investment tax credit to stimulate the economy and encourage investment. For certain regulated utility taxpayers, Congress has restricted the availability of these benefits to those utilities which have their rates set in accordance with certain requirements set out in the Internal Revenue Code and Treasury Regulations. Failure to satisfy these requirements will make the utility ineligible for these tax benefits and thereby substantially increase the utility's federal tax liabilities.

Therefore, the availability of these tax benefits rests with the state regulatory body which sets the utility's rates. If a regulatory agency prescribes a ratemaking method which is inconsistent with the requirements of the tax law, the utility will no longer qualify for these benefits. If a regulatory agency issues a rate order which includes a questionable interpretation of the requirements of the tax law, the utility has no judicial recourse which will bind the regu-

[1] Sponsored by the Honorable Vernon L. Stnrgeon, of California, adopted Aug. 16, 1979, reported NARUC Bulletin No. 36–1979, pp. 8–9.

latory agency, the Internal Revenue Service, and the utility itself to a decision as to whether the regulatory agency correctly applied the federal tax law.

Appeal of the agency's order through the state courts will not bind the IRS. Section 1342 of the Judicial Code (The Johnson Act) severely restricts review of state rate orders in Federal courts. Section 2201 of the Judicial Code (The Declaratory Judgment Act) with one exception for tax exempt organizations, prohibits the issuance of declaratory judgments with respect to tax controversies. Consequently, appeal from an IRS ruling of ineligibility must await completion of IRS audits many years after the regulatory agency's decision has been in effect. During this time, the utility will have been exposed to very substantial, cumulative federal tax liabilities.

For example, in California, the Public Utilities Commission has ordered that the Pacific Telephone and Telegraph Company make refunds to ratepayers of approximately $270 million and $60 million per year on an on-going basis, based on the Commission's interpretation that certain new ratemaking techniques were consistent with requirements of the Internal Revenue Code. The IRS, in two revenue rulings issued in June and July, 1978, has indicated that the Commission's order will disqualify Pacific Telephone for liberalized depreciation and investment tax credit. The California Commission refused to participate in the ruling requests and has decided to ignore the IRS rulings. On July 13, 1978, the California Supreme Court denied Pacific Telephone's petition for review, and on December 11, 1978, the United States Supreme Court also denied Pacific Telephone's request for review. Pacific Telephone then filed a petition for rehearing with the United States Supreme Court and this petition was denied on February 21, 1979. A petition for rehearing is still before the California Commission.

If a rehearing is denied by the Commission, Pacific Telephone will be required to make the ordered refunds and collect reduced rates on an on-going basis. In the meantime, the audit of Pacific Telephone's tax returns for the years 1974 through 1976 are not likely to be completed until sometime late in 1979 or early 1980. The tax proceedings are not expected to be concluded until the end of 1983 at which time Pacific Telephone's possible tax liability, including interest, will be in excess of $3 billion.

Had legislation similar to the proposed legislation been in effect, Pacific Telephone would have obtained judicial review in the federal courts as to its eligibility for the tax benefits under the Commission's order which would have bound the California Commission, Pacific Telephone and the IRS. If the proposed legislation is enacted shortly, Pacific Telephone may still obtain expedited judicial review which would limit its enormous potential liability for taxes.

Legislative History—Accelerated Depreciation (Section 167, Internal Revenue Code)

In the 1954 revision of the Internal Revenue Code (Public Law 83-591), Congress first enacted a provision to permit accelerated depreciation of qualified property, which included the double declining balance method and the sum-of-the-years' digits method.

Congress reasons for allowing more rapid depreciation were stated in the House Ways and Means Committee Report:

"More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax write-off would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living." (H. Rept. No. 1337, 83d Cong., 2d Sess., p. 24.)

Under the 1954 law, regulated industries could, just as other taxpayers, elect to use straight-line or an accelerated method of depreciation. But controversies arose as regulatory agencies began to require the utilities using accelerated depreciation to flow through the resulting reduction in federal income taxes to

the utility s customers to lower the customer's service rates. This action by regulatory commissions eliminated the working capital Congress intended to provide and resulted in a loss of Treasury revenues.

"This is because the current tax reduction reduces the rates charged to customers which in turn reduces the utility's taxable income and, therefore, reduces its income tax. This second level of tax reduction is passed on to the utility's customers, with the same effect." (House Ways and Means Committee, H. Rept. No. 91–413 (Part 1), 91st Cong., 1st Sess., at 132 (1969).)

Therefore, in 1969 Congress enacted the Tax Reform Act of 1969 which provided that utilities (such as the Bell System companies) which had not been claiming accelerated tax depreciation may do so only if they normalize for accounting and rate-making purposes. Other utilities that had been flowing through the benefits of accelerated depreciation could continue to do so.

The General Explanation of the Tax Reform Act of 1969 prepared by the staff of the Joint Committee on Taxation, described the provision as follows:

"In general the Act provides that if a company (a) is in one of the regulated industries to which the Act applies and (b) as of August 1, 1969, either took accelerated depreciation and normalized its deferred taxes or took straight-line depreciation, then the company is permitted to take accelerated depreciation on its tax return only if it normalizes on its regulated books of account and for rate-making purposes. Companies that used flow-through as of August 1, 1969, unless certain elections are made, are to continue to do so." (Geueral Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., Public Law 91–172, prepared by the staff of the Joint Committee on Taxation.

The statutory definition of flow-through and normalization was also provided by the Tax Reform Act of 1969. The accounting method known as normalization was outlined by the staff of the Joint Committee on Taxation.

"Normalization involves computing the greater federal income tax liability which would have been incurred had the utility used straight-line depreciation, including the additional taxes in current expenses, and then adding this amount to a reserve for future tax expense. The customer's costs then are the same as they would be under straight-line depreciation and the utility has the cash which may be used for capital investment, current expenses, or any other corporate uses in the same way in which funds generated by a depreciation reserve may be used. Even under this method the regulatory agency may, however, exclude the reserve from the base on which it computes its rates and in this manner give the customer the benefit of its use without providing the utility with a return on this amount." (Treatment of Tax Depreciation by Regulatory Agencies, prepared by the staff of the Joint Committee on Taxation, July 16, 1969.)

The flow-through method uses accelerated depreciation in computing both the actual income tax liability of the public utility as well as for determining the income tax expense for book and rate-making purposes. The flow-through method permits current income to be charged only with the lower income taxes actually paid as a result of the larger accelerated depreciation deduction in the early life of the asset. Regulatory agencies require the tax reduction resulting from accelerated depreciation to be flowed-through to the current customer as a reduction in the price of utility service. There is no deferred tax reserve to provide for future tax liabilities which will occur with accelerated depreciation because in the later life of the asset the amount of depreciation will provide much smaller deductions to offset income.

The Senate Finance Committee Report explains some of the very specific requirements the committee added to the statute to define for regulatory agencies the proper method of setting rates where accelerated depreciation is involved. (S. Rept. No. 91–552, 91st Cong., 1st Sess., at 152–153 (1969).)

The Act did not change the power of the regulatory agency in the case of normalization to exclude the normalization reserve from the base upon which the agency computes the company's rate of return. (S. Rept. No. 91–552, 91st Cong., 1st Sess., at 152 (1969).) Therefore, the tax law does not require that utilities earn on this reserve.

In requiring the tax benefits of accelerated depreciation to be normalized, Congress accepted the arguments of advocates whose testimony at public hearings was summarized by the staff of the Joint Committee on Taxation.

"The 'normalization' method involves setting up a reserve account for deferred taxes, recognizing the future liability for increased federal income taxes when the depreciation deduction declines over the life of the asset. The use of cost-free

capital is the benefit distributed to the consumer over the life of the asset through the use of the tax deferral account. The advocates of normalization maintain that this method of accounting for accelerated depreciation avoids charging future customers with increased taxes resulting from earlier use of a disproportionately large tax deduction attributable to the utility property that serves them." (Summary of Testimony on Treatment of Tax Depreciation by Regulatory Agencies at Public Hearings held by the Committee on Ways and Means. Prepared by the staff of the Joint Committee on Taxation July 11, 1969.)

LEGISLATIVE HISTORY—INVESTMENT TAX CREDIT (ITC) (SECTIONS 38 AND 46, INTERNAL REVENUE CODE)

I. SUMMARY OF THE LEGISLATIVE HISTORY

Revenue Act of 1962 (Public Law 87-834)	ITC adopted to stimulate investment; 7-percent-standard credit; 3 percent for public utilities.
Public Law 89-800	Suspended ITC from Oct. 10, 1966, to Mar. 10, 1967.
Tax Reform Act of 1969 (Public Law 91-172)	Repealed ITC.
Revenue Act of 1971 (Public Law 92-178)	ITC reenacted; 7-percent-standard credit; 4 percent for public utilities.
Tax Reduction Act of 1975 (Public Law 94-12)	Increased ITC to 10 percent for all taxpayers until Dec. 31, 1976. Public utilities were permitted to offset up to 100 percent of tax liability in 1975 and 1976; thereafter, to be phased down by 10 percent each year, to the standard 50 percent limitation applicable to all taxpayers by 1980.
Tax Reform Act of 1976 (Public Law 94-455)	Extended ITC at 10 percent until Jan. 1, 1981.
Revenue Act of 1978 (Public Law 95-600)	Permanent ITC at 10 percent: offset up to 90 percent of tax liability; extended credit to certain structures.

NOTE.—The additional 1½ percent ITC for Employee Stock Ownership Plans is not covered herein.)

II. THE REVENUE ACT OF 1971 (PUBLIC LAW 92-178)

The Revenue Act of 1971 set out the present rules for treatment of the ITC in rate-making proceedings:

"In restoring the investment credit for public utility property of regulated companies, the committee has given careful consideration to the impact of this credit on rate-making decisions. Although there are many different ways of treating the credit for rate-making purposes, your committee, in general believes that it is appropriate to divide the benefits of the credit between the customers of the regulated industries and the investors in the regulated industries." (Ways and Means Committee, H. Rept. No. 92-533, 92d Cong., 1st Sess., at 24 (1971).)

Congress decided it would not be appropriate to flow through the benefits of the ITC to the utility's customers.

"To permit all the benefits of the credit to be flowed through to the customer currently could have an impact on revenues which is approximately twice that applicable in other cases. Moreover, the basic purpose of the investment credit is not an allocation of resources which will stimulate consumption of any particular type of product or service." (Ways and Means Committee, H. Rept. No. 92-533, 92d Cong., 1st Sess., at 24 (1971).)

Identical language also appears in the report of the Senate Committee on Finance. S. Rept. No. 92-437, 92d Cong., 1st Sess., at 36 (1971).

"For these reasons, as a general rule, the bill does not make the credit available where all the benefit from it would be flowed through currently to the customers."

The Act provided three options to public utilities for treatment of ITC, which the utility had to elect within 90 days of enactment of the 1971 Revenue Act. (See Conference Report, H. Rept. No. 92–708, 92d Cong., 1st Sess., at 38 (1971).)

Option 1.—The credit may not be flowed through to income but may be used to reduce the rate base (provided that this rate base reduction is restored not less rapidly than ratably over the useful life of the property).

Option 2.—The credit may be flowed through to income (but not more rapidly than ratably over the useful life of the property) and there must not be any adjustment to reduce the rate base.

Option 3.—Immediate flow-through of the credit, but this option was available only by a utility which previously used flow-through accounting in connection with the accelerated depreciation of its post-1969 property.

III. THE TAX REDUCTION ACT OF 1975 (P.L. 94–12)

In 1975, Congress increased the ITC to 10 percent for all taxpayers. Although the principal focus of the 1975 Act was tax reduction, the Ways and Means Committee sought a balance between economic stimulus to consumption and the stimulus to business investment to provide jobs and increase productivity.

"In view of the low and decreasing level of economic activity and the poor expected level of investment, your committee concluded that a balanced program which encourages both consumption and investment will be a more effective method of stimulating the economy than attempting to focus all of the tax stimulus on consumption. In addition to providing short-run stimulus to the economy, an increase in the amount of investment is desirable for other reasons. The investment not only creates jobs both directly and through the multiplier effect in the short run, but it also increases productivity. This is anti-inflationary because it increases the amount of output available to meet future consumer demands and because it results in lower production costs which means that money wage increases will not exert the same degree of upward pressure on product prices that they would in the absence of growing productivity. Increased productivity also has favorable implications for our balance of payments and the exchange rate of the dollar. Finally, unless in the future the stock of capital is increased significantly, there will be serious problems in providing enough jobs for those entering the labor force. In view of these considerations your committee concluded that it would be appropriate to increase the investment credit rate to 10% from the 7-percent rate currently available." (H. Rept. No. 94–19, 94th Cong., 1st Sess., at 11–12 (1975).)

In recommending an increase in the ITC from 4 to 10 percent for utilities, the Ways and Means Committee Report stated:

"Under existing law, a 4 percent investment credit is provided for most public utilities, as compared to the 7 percent-investment credit which applies generally. This lower investment credit for public utilities discriminates against investment in utilities and impedes such investment at a time when the public utilities need such large amounts of capital to build up their capacity to meet the growth in demand for their services. Public utilities have experienced very considerable difficulty in recent years in securing capital for essential expansion in view of the depression state of the stock market, tight money, and the reluctance of regulatory commissions to grant rate increases to cover increased costs." (Ways and Means Committee, H. Rept. No. 94–19, 94th Cong., 1st Sess., at 12 (1975).)

Under the House bill (after a very close vote in the House Ways and Means Committee), a limit of $100 million was imposed on the increase in the investment credit that could be claimed by any one taxpayer by reason of the increase in the rate of the investment credit. The Senate Finance Committee deleted this limitation. (S. Rept. No. 94–36, 94th Cong., 1st Sess., at 42) In fact, the limit applied only to one taxpayer, AT&T, as the Senate Finance Committee report concluded. The Conference Committee agreed with the Senate's deletion of this limitation. (H. Rept. No. 94–120, 94th Cong., 1st Sess., at 63 (1975).)

The Tax Reduction Act of 1975 further restricted the use of the flow-through method of accounting for the 6 percent increase in the credit (4 to 10 percent) for public utility property. Congress provided that all utilities must use a normalization method of accounting for the 6 percent increase in the credit. Even those utilities allowed to use the flow-through method under the 1971 Act were

required to normalize the increase in the investment credit unless they specifically elected immediate flow-through within 90 days of the enactment of the 1975 Act.

IV. THE REVENUE ACT OF 1978 (PUBLIC LAW 95-600)

As recommended by President Carter, Congress made the investment tax credit permanent at a 10 percent rate and increased the present offset against tax liability to up to 90 percent.

"Since its enactment in 1962, the investment tax credit has been an effective incentive to investment in qualified equipment. Statistics on such investment show a positive relationship between the level of investment and the enactment, reenactment, suspension, repeal, or a change in the rate of the credit. Investment has increased when the credit has been available and decreased when the credit was rescinded. The effectiveness of the credit arises from the fact that it reduces the purchase price of the equipment and in effect increases the net cash flow after taxes to the investor." (Ways and Means Committee, H. Rept. No. 95-1445, 95th Cong., 2d Sess., at 82 (1978).)

CALIFORNIA PUC DECISION

Decision No. 87838 of the California Public Utilities Commission was issued September 13, 1977 in a rate decision involving Pacific Telephone and Telegraph Company and General Telephone Company. The decision followed hearings on remand of a prior Commission Order by the California Supreme Court. The remand was limited to the consideration and determination of the proper treatment of accelerated depreciation, ADR, the class life system, and the investment tax credit in determining rates for service.

The decision orders refunds for the period beginning August 17, 1974, through December 31, 1977, in the sum of $205,856,000, including interest, and a reduction of on-going annual rates of $60,494,000. It uses a methodology which the Commission states is consistent with the requirements set out in the Internal Revenue Code by Section 167 (*l*) (3) (G) for depreciation and by Section 46 (f) (2) for the investment tax credit, so as to preserve Pacific's eligibility for accelerated depreciation, ADR, the class life system, and the investment tax credit.

To remain eligible for accelerated depreciation, the Internal Revenue Code requires a utility to use the normalization method of accounting. Normalization involves computing the greater federal tax liability, which would have been incurred had the utility used straight-line depreciation, and then adding this amount to a reserve for future tax expense. The regulatory agency may exclude the reserve from the base on which it computes its rates, which would prevent the utility from earning a return on this amount.

The Commission's method, referred to as "averaged annual adjustment," reduces Pacific's net revenue requirement for the test year by an amount determined by multiplying the average of Pacific's deferred tax reserve for the test year and the three succeeding years by Pacific's authorized rate of return. This is equivalent to reducing Pacific's rate base for the test year by the four-year average deferred tax reserve. This four-year average deferred tax reserve is greatly in excess of the deferred tax reserve for the test year. However, under the Commission's method, the tax expense used to compute cost of service for ratemaking purposes is only the tax expense for the test year instead of using a four-year average tax expense.

In the case of the investment tax credit, the rules of Section 46 (f) (2) are intended to insure that the credit is not flowed through currently to the taxpayer's customers but rather is flowed through ratably over the life of the property which gave rise to the credit. Under Section 46 (f) (2), one of the options provided for in the Internal Revenue Code, eligibility for the credit can be maintained only if the credit is flowed through as a reduction in cost of service no more rapidly than ratably over the period for which depreciation expense is recognized on the property that produced the credit. In addition, to assure that there is not excessive flow-through, Section 46 (f) (2) provides that the rate base may not be reduced by reason of any portion of the credit.

The "annual adjustment" to rates required by the Decision is inconsisent with both of these rules. The Decision requires the amount of investment credit amortization to be recalculated each year to reflect anticipated investments in new property, without adjusting the rate base, depreciation expense, or other

cost of service factors which would increase as new investments are acquired. Therefore, this method reduces the cost of service by more than a ratable portion of the credit which results in loss of eligibility.

DECISION NO. 87838, SEPTEMBER 13, 1977, BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application No. 53587 (Filed September 19, 1972)

In the matter of the Application of the Pacific Telephone and Telegraph Co., a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.

Application No. 51774 (Filed March 17, 1970)

In the matter of the Application of the Pacific Telephone & Telegraph Co., a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.

Application No. 55214 (Filed September 30, 1974; amended December 13, 1974)

In the matter of the Application of the Pacific Telephone & Telegraph Co., a corporation, for telephone service rate increases to offset increased wage, salary and associated expenses.

Case No. 9503 (Filed January 30, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the Pacific Telephone & Telegraph Co.

Case No. 9802 (Filed November 26, 1974)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of the Pacific Telephone & Telegraph Co.

Case No. 9832 (Filed November 26, 1974)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of the Pacific Telephone & Telegraph Co., a California corporation.

Application No. 51904 (Filed May 15, 1970; amended July 17, 1970)

In the Matter of the Application of General Telephone Co. of California, a corporation, for authority to increase its rates and charges for telephone service.

Application No. 53935 (Filed March 28, 1973)

In the Matter of the Application of General Telephone Co. of California, a corporation, for authority to increase its rates and charges for telephone service.

Case No. 9100 (Filed August 4, 1970)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of General Telephone Co. of California.

Case No. 9504 (Filed January 30, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of all the telephone corporations.

Case No. 9578 (Filed July 3, 1973)

Investigation on the Commission's own motion, into the rates, tolls, rules, charges, operations, costs separations practices, contracts, service, and facilities of General Telephone Co. of California, a California corporation; and of the Pacific Telephone & Telegraph Co., a California corporation.

OPINION

This is the latest, and hopefully the final, proceeding on the long and tortuous road involving the regulatory rate treatment of accelerated tax depreciation (which includes asset depreciation range, class life system, salvage value, and repair allowance) and the Job Development Investment Credit, now called the Investment Tax Credit (ITC), for two major California telephone utilities, The Pacific Telephone and Telegraph Company (Pacific), and General Telephone Company of California (General). This proceeding results directly from the remand by the California Supreme Court in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680, which annulled that portion of the rate increase granted Pacific in D. 83162 dated July 23, 1974 which related to accelerated tax depreciation and ITC. (All other matters decided in D. 83162 were affirmed by the court.) This annulment also applied to General because in D. 83778 dated November 26, 1974 General's accelerated tax depreciation and ITC were treated by this Commission in the same manner as was Pacific's in D. 83162.

At the time the above decision was filed by the court, there was under submission another rate increase proceeding for Pacific, A. 55214, in which we issued D. 85287 on December 30, 1975. D. 85287 granted a rate increase subject to refund to provide for any adjustment in the rates that might be required as a result of the hearings in the instant proceeding. In addition, at the time this matter was remanded by the court two rate increase applications, A. 55492 for Pacific and A. 55383 for General, were pending. The accelerated depreciation and ITC issues in those proceedings were removed for final determination in this proceeding.

In the remanded matters this Commission had set rates based on the normalization method of accounting,[1] which involves the computation of rates based on the same method of depreciation, both for depreciation expense and federal income tax expense, while the federal income taxes are actually paid on the basis of a different amount of (accelerated) depreciation expense. Since accelerated depreciation substantially increases the allowable expenses to the utility, the taxable income, and therefore the federal income tax expense of the utility, is substantially below what it would have been had taxes been paid on the ratemaking (stralght-line) depreciation basis. The difference between the amount of taxes computed on a straight-line depreciation basis and an accelerated depreciation basis is reflected in a reserve account called the deferred tax reserve. This amount, on an average basis, is deducted from rate base so that the authorized rate of return is not earned on this sum. The deferred tax reserve accumulates from year to year disproportionately to revenues, expenses, and rate base as long as the overall plant additions by the utility continue to grow. To this extent, the taxes set aside in the deferred tax reserve shall never be paid and amount to an actual tax saving, rather than only a deferral. (ITC is defined as a tax credit, thus is a direct tax saving and not a deferral.)

In the remand of D.83162 the Supreme Court held, inter alia, that this Commission has the power to implement an alternative method, e.g., an annual adjustment, of tax expense treatment for accelerated depreciation and ITC. This annual adjustment method was discussed but not used in arriving at the treatment set forth in D.83162. The Supreme Court ordered this Commission to give

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[1] Internal Revenue Code (IRC) Section 167(L)(3)(G), which reads as follows:
"(G) Normalization method of accounting.—In order to use a normalization method of accounting with respect to any public utility property—
(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expenses for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

consideration to this method, as well as other alternatives, including the possibility of a commensurate adjustment in the rate of return, and to provide for refunds, if appropriate.

Hearings on this remand were held between March 1, 1976 and July 9, 1976 before Commissioner Robert Batinovich and Examiner Phillip E. Blecher. The matter was submitted on the latter date subject to the filing of briefs.

The Proposed Report of the examiner was issued on January 19, 1977. Exceptions to the Proposed Report were timely filed by Pacific, General, City of Los Angeles (LA), and Toward Utility Rate Normalization (TURN). These exceptions shall be discussed where appropriate.[2]

Review

D.83162, 83778, and 85287 have exhaustively reviewed and discussed this tax expense issue from its inception. We shall not reiterate that discussion, but shall attempt to confine the review of evidence and discussion of the issues to those old matters still pertinent here, as well as the new matters not previously raised. However, we think a brief recounting of three California Supreme Court decisions relating to this issue is warranted.

Case 1: *City and County of San Francisco* v. *Public Utilities Commission, et al.* (1971) 6 C 3d 119. This case annulled D.77984, which had provided that Pacific could use accelerated depreciation with the normalization method of accounting as defined in IRC Section 167, because this Commission failed to consider lawful alternatives in the calculation of federal income tax expense. On page 130 the court said: "Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax law are either harsh on the utility or the ratepayers, the Commission may also consider alternative approaches which strike a balance between these two extremes." This statement was quoted with approval in Case 3, infra. Since there has been no substantive change in the applicable federal tax statutes, this quotation is as appropriate today as when made,

Case 2: *City of Los Angeles* v. *Public Utilities Commission*—(1972) 7 C 3d 331. A general rate increase for Pacific was annulled partly because the Commission computed taxes on the basis of normalization.

Case 3: *City of Los Angeles* v. *Public Utilities Commission*—(1975) 15 C 3d 680. This is the case which remanded D.83162, et al., for these proceedings. The court stated on page 684 that the Commission took the action in D.83162 in spite of the court having annulled its previous decision in this matter for failure to consider lawful alternatives in the calculation of federal income tax expense (Case 1). The court further said that the Commission set a rate which in its own words would create a windfall for the telephone companies to the detriment to the ratepayers.

Pursuant to the remand in Case 1 the Commission entered D.80347 dated August 8, 1972 which directed further hearings into the tax expense problems. There further hearings had not yet been held at the time of the decision in Case 2. In D80347 we said on page 3: "For the purpose of this opinion only we will compute Pacific's federal tax expense on the basis of accelerated depreciation with flow-through." D.80347 thus ordered a substantial refund amounting to about $176 million, including interest, based on the flow-through method of computation of the federal tax expense. D.80347 also set rates which were in effect through the effective date of D.83162 rates, which was August 17, 1974. The hearings held pursuant to Case 1 were consolidated with A.53587 and resulted in D83162 where this Commission again adopted the normalization basis for computing federal tax expense, which resulted in Case 3.

In D. 74917 dated November 6, 1968, prior to the enactment of the Tax Reform Act of 1969(TRA) effective January 1, 1970, we determined that Pacific was imprudent in not electing the accelerated depreciation option. For ratemaking purposes we imputed accelerated depreciation with full flow-through, though Pacific was paying taxes on a straight-line basis. This procedure was approved in Case 1. TRA allowed utilities to take accelerated depreciation even though they had not taken it before 1969 only if the cost of service (which includes federal income tax expense) was computed on a normalization basis. After the enactment of TRA both Pacific and General reversed their long-standing op-

[2] All transcript corrections requested after the date of submission by Pacific, General, and LA have been adopted.

position to accelerate depreciation and elected it on a normalization basis. This election has resulted in the instant proceedings in which we are attempting to comply with the mandate from our Supreme Court to reach an equitable determination of this problem.

Pacific and General argue that accelerated depreciation is allowable only if normalization accounting is used because neither is eligible under IRC Section 167.1 for flow-through accounting. If normalization is not used, then the companies must revert to straight-line depreciation and the benefits of accelerated depreciation will be lost to both the utilities and the ratepayers. We have previously agreed with this position, as has the court in Case 1, though this result is due only to the intransigence of Pacific and General in not opting for accelerated depreciation when they had the opportunity. While this Commission deplores the actions of Pacific and General, we are again compelled to agree with their interpretation of the tax law. To impute flow-through now in attempting to redress the balance between the utilities and ratepayers, we would ultimately cause the ratepayers substantially higher rates and poorer service while seriously damaging the financial position of the companies. This horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator.

Thus, we are forced to again consider the question of maintaining eligibility for accelerated depreciation on a normalized basis. The primary reference for this purpose is Treasury Regulation 1.167(l)-(1)(h)(6).[3] It delineates when the normalization method of accounting is not used, and concomitantly, when it is used. If these criteria are not met, then accelerated depreciation in its entirety will be disallowed creating a huge tax liability for Pacific and General, which will be met with an equally huge deferred tax reserve account, which is paper only, as the monies credited to the deferred tax reserve have already been spent.

The same proposition prevails for ITC. Since ITC became effective in December 1971, General and Pacific have elected ratable (service-life) flow-through (Option 2).[4] This means that the amount of plant investment in the taxable year shall be apportioned on its expected service life for ratemaking purposes.

Neither Pacific nor General was eligible for ITC Option 3[5] (see Case 1, page 130), which allows full flow-through of the tax saving in the year in which the benefit occurred.

Thus, ITC for Pacific and General will be disallowed in its entirety if the taxpayers' cost-of-service for ratemaking purposes is reduced by more than a ratable portion of the credit allowed or if the base to which the taxpayers' rate of return for ratemaking purposes is applied is reduced by more than a ratable portion of the credit.

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[3] This regulation, as far as pertinent, reads as follows:

"(6) Exclusion of normalization reserve from rate base. (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(L) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking."

[4] IRC Section 46(f)(2), which reads as follows:

"(2) Special rule for ratable flow-through.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

"(A) Cost of service reduction.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

"(B) Rate base reduction.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection)."

[5] IRC Section 46(f)(3), which reads as follows:

"(3) Special rule for immediate flow-through in certain cases.—In the case of property to which section 167(L)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraphs (1) and (2) shall not apply to such property."

Assumptions

This discussion and ensuing decision reflect the assumptions set forth below:

(1) Tax Reduction Act became effective on January 1, 1970.

(2) As a result of Case 1 and D. 80347, Pacific's rates from January 1, 1970 to August 17, 1974 have been promulgated on a flow-through basis. Since these rates are final they cannot now be amended by any action of this Commission. Therefore (a) any action taken in respect to Pacific's rates will apply from August 17, 1974 until the effective date of the rates set in D. 85287, which is January 5, 1976; (b) the rates set in D. 85287 are subject to refund and any action taken in this decision shall adjust those rates accordingly; and (c) any action taken here shall apply prospectively to the rates to be set in pending A. 55492 of Pacific.

(3) General's rates for test year 1970 in D. 79367 (effective December 12, 1971) and thereafter have been subject to refund. Therefore (a) any action taken on accelerated depreciation here shall apply to the rates collected by General from December 12, 1971; (b) although ITC was not in existence in test year 1970 used in D. 79367, any action taken on ITC shall apply from December 12, 1971, as General has been taking ITC since it has been available; and (c) any action taken here on ITC and accelerated depreciation shall apply prospectively to the rates to be set in pending A. 55383 of General.

(4) Neither Pacific nor General has the option to elect accelerated depreciation on a flow-through basis under IRC Section 167, et seq. (Case 1.)

(5) Both Pacific and General must use a normalization method of accounting to maintain eligibility for accelerated depreciation under IRC Section 167, et. seq.

(6) Neither Pacific nor General has the option to elect ITC on a flow-through basis (Option 3) under IRC Section 46, et seq.

(7) Normalization accounting for accelerated depreciation reduces financial risk and increases cash flow compared to the flow-through treatment for accelerated depreciation.

(8) Both Pacific and General were guilty of imprudent management in their original determination to pay federal income taxes on a straight-line depreciation basis. (Cases 1 and 3.)

(9) The quantification of a rate of return reduction because of the increased cash flow and decreased risk and vulnerability of normalization accounting is difficult and jndgmental.

The evidence

Various alternative methods presented at the hearings may be summarized as follows:

General's proposals

1. Three-Year reserve and tax adjustment method.—This is a variation of a previously proposed three-year pro forma method which, it was argued, was disqualified under Treasury Regulation 1.167(l)-(1)(h)(6) because it used a deferred tax reserve balance that exceeded the amount of such deferred tax reserve for the period used in determining the taxpayers' tax expense. The current proposed method remedies this defect because it considers the additional tax expense for the same period as the deferred tax reserve. It is based on the assumption that the federal income tax will increase in proportion to growth after the test year. The method of computation is as follows:

At test year the Commission should find a reasonable federal income tax (before ITC) and a reasonable normal growth rate. (General recommends using the compound growth in main stations for the three preceding years.) The test year tax expense would then be increased by applying the growth factor to the intrastate federal income tax (before ITC) for three years into the future and averaging. The test year federal tax expense would then be deducted from the three-year average to determine the additional tax expense to be included in the test year. This amount would then be multiplied by the net-to-gross multiplier to represent the interstate change in revenne requirement related to the additional tax expense that must be considered for the same period as the deferred tax reserve as determined in the three-year pro forma method.

2. Annual reserve and tax adjustment.—This is an adaptation of the annual or year-to-year adjustment method (which the Supreme Court discussed in Case 3), which has the same disadvantage as the pro forma method because of its use of an out-of-period deferred tax reserve. The current adaptation of this method

makes an annual adjustment for the increase in reserve and also brings the additional tax expense forward for the same time period. The additional tax expense is determined in the same manner as in the three-year reserve and tax adjustment method, but the rates would only be adjusted one year at a time. The federal income tax before ITC, plus a normal growth rate, would be determined by the Commission and each year's calculation would be based upon the prior year's calculation until a new test year was established.

3. The defered tax reserve as no cost capital.—This method is used by applying the amount in the deferred tax reserve as a component of the capital structure with zero cost assigned to it. Rate base is not reduced by the amount of deferred tax reserve. The effect is to lower the cost of capital and rate of return found reasonable in general rate proceedings.

Pacific's proposal

Annual ratemaking plan.—Pacific would annually tender an estimated full intrastate cost of providing telephone service, keeping as constant all the ratemaking adjustments previously adopted in the latest general rate decision and the last authorized rate of return. No new adjustments or change in authorized rate of return would be permited but all other elements of cost-of-service would be considered. This is a slightly simplified aunual rate case, which everyone agrees is permited under the existing tax laws.

Staff's proposels[6]

1. Pro forma annual adjustment.—Gross revenue requirement reductions are determined by annual adjustments in the deferred tax reserve for the test year and each of the next three years. The average of these four years' reductions is then applied as a gross revenue reduction in test year rates.

2. Rate of return adjustment—Reduced risk.—The authorized rate of return upon which test year gross revenue requirements are based is reduced in order to recognize the reduction of financial risk resulting from the cash flow generated by the tax savings from accelerated depreciation and ITC on a normalization accounting basis.

3. Midpoint flow-through applied to a normalization rate base.—In addition to the normalized treatment of deferred tax reserve, one-half of the difference in gross revenue requirements between normalization (for accelerated depreciation) and ratable flow-through (for ITC) and a full flow-through of each is reflected in rate reductions.

4. Normalization with amortization of deferred taxes.—This is similar to the method of adjusting the expense and rate base for contributions in aid of construction. The gross revenue requirements are reduced by the reduction in rate base in the amount of the average deferred tax reserve for the test year, but the deferred tax reserve is also amortized (using the straight-line depreciation rate) by a sum also reflected in a reduction in gross revenue requirements and rates.

5. Rate of return adjustment—Cost-free funds.—This is substantially equivalent to General's no-cost capital proposal.

City and County of San Francisco's (SF) Proposal

SF recommends full flow-through, or in the alternative, a rate of return reduction contingent upon a favorable IRS ruling on eligibility, but in the event of an unfavorable ruling, rates to be then reset on a full flow-through basis. The purpose of this theory is to provide the companies with an incentive to obtain a favorable tax ruling, or, alternatively, to amend the existing law to avoid the loss of eligibility.

City of Los Angeles's (LA) Proposal

LA recommends a rate of return reduction up to a maximum of two percentage points,[7] while continuing the normalization treatment of tax expense. This reduction is to be quantified after considering three factors:

(1) Analysis of the financial risk reduction of a normalization as compared to a flow-through company due to the greater cash flow generated, the reduction of the need for outside financing, the reduction of the cost of embedded debt,

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[6] Staff refers to the Utilities Division of the Commission.

[7] For test year 1975–76, the staff calculates that the rate of return for Pacific would be 2.17 percentage points higher on a flow-through basis than on a normalization basis.

the improvement in interest coverage, and the generally favorable effect on the cost of new capital and evaluation of the utility's securities generally. (This position is supported by the city of San Diego.)

(2) The previously found imprudent management in failure to elect accelerated depreciatiou to avoid rewarding the utilities for their imprudence.

(3) Reflection of the phenomenon of inverse attrition, which is the opposite of the aliowance for attrition that the Commission has used in the past as a regulatory tool where there is a projected diminution of the rate of return. Here, since the norma'ized tax reserve grows at a markedly greater rate than the other components of the utility's operations, the authorized rate of return would be exceeded in subsequent years because uo reduction in rate base occurs between test years. The inverse attrition allowance set in the test year will reduce the rate of return in the future. (This is a step beyond the continuous surveillauce method now in use, which only applies to earnings in excess of the authorized rate of return.)

LA recommends that ITC be treated in the same manner.

Toward utiltiy rate normalization's (TURN) proposal

Turn proposes another method of compensating for the reduced risk of normalization by reducing the rate of return. It is calculated by discounting to present vaiue the money which is accumulated in the deferred tax reserve and the measuremeut of that time value upon the rate of return allowed in addition to the normalization treatment. The method also applies to ITC using a three-year forward averagiug amount (test year and two following years). In the beginning this method wonld produce a refund in excess of the refund produced by full flow-through.

Other positions

Citizens Action League (CAL).—CAL supports a greater sharing of the benefits of accelerated depreciation with ratepayers than exists under normalization accounting, and urges refunds be paid in cash rather than as a bill credit.

Continental Telephone Co. of California.—This company would be affected by our decision here only if a refund of toll revenues collected by Pacific should be ordered.

The Los Angeles Urban League.—This organizations seeks equal opportunities for blacks and other minorities in all sectors of our society and is concerned over a decision adverse promotion practices under Pacific's scenario of service and hiring, firing, and promotion practices under Pacfic's scenario of service and construction reductions.

Los Padrinos, Inc.—This is a nonprofit charitable and educational corporation of predomiuantly Spanish-surnamed employees of Pacific. It is also concerned about the serious economic consequences depicted by Pacific's witnesses and nrges the Commissiou to adopt an alternative which will preserve Pacific's eligibility for tax benefits.

The National Association for the Advancement of Colored People (NAACP).—NAACP is a civil rights organization with the principal purpose of eliminating racial discrimination in every facet of American life. It urges the Commission to allow Pacific the full tax advantages of accelerated depreciation and ITC to preserve the employment of ethnic minorities and aid in employing the large number of unemployed black persons.

The Pacific Telephone Employees for Women's Affirmative Action, Southern California.—This is an organization dedicated to aiding Pacific in achieving its affirmative action goals relating to women and urges action similar to the other above-mentioned groups.

Discussion

Oue of the major difficulties in the resolution of these cases is the length of time that has trauspired between the onset of the problem and its latest submission for resolution. In Case 1 the court recognized then (in 1971) that one extreme or the other in the solution would be harsh to either the utilities or the ratepayers. That proposition has now been exacerbated by the passage of years and many millions of dollars of increase in the deferred tax reserve. Now, in the event of the loss of eligibility for the tax benefits flowing from accelerated depreciation aud ITC, Pacific estimates its total potential tax liability here from 1970 through the end of 1976 at $764 million, while General estimates its comparable liability at $223 million, or together almost $1 billion in potential

tax liabilities. This is without regard for any rate refunds, ongoing rate reductions, and other costs that might be attributable to a retroactively assessed tax liability, such as the need for raising additional funds for plant investment, the deterioration in financial position, the necessity for increased interest rates and returns on debt and equity, and a myriad of other problems involved, not the least of which are the staggering rate increases that are foreseeable as the bottom line in such scenario. We are seeking to resolve this dilemma in a middle ground, perhaps pleasing no one, but finally disposing of this problem by more suitably leveling the interest of the utilities and the ratepayers. Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis.

Accelerated tax depreciation

The parties recommend various positions which encompass the entire spectrum of possibilities from maintaining the status quo with normalization to a method which would refund more money than would be available under flow-through. While the alternatives submitted are plentiful, all are substantially variations on two themes: (1) reduction of rate of return; and (2) some form of reflecting the increase in the deferred tax reserve in order to further reduce the rate base (the annual adjustment method).

The utilities would pefer to maintain the status quo, though Pacific condescended to advocate what amounts to an annual rate case, merely holding the rate of return and any other test year adjustments constant while delving into the entire cost of service each year, a solution that will solve nothing while adding to the specter of regulatory lag.

General was somewhat more generous by offering additional variations on the annual adjustment, while offsetting the increased deferred tax reserve with increased federal tax expense.

The staff basically recommended full flow-through but as a concession to compromise supported a rate of return reduction based on reduced risk only for future rates and a refund based on full flow-through for the rates subject to refund. LA recommended a maximum two percentage point rate of return reduction for the current test year 1975–1976 for Pacific, although it supports flow-through as the only proper ratemaking approach.

For General's test years the rate of return difference between flow-through and normalization was .14 percentage points in test year 1970, 1.39 in test year 1974, and 1.58 in test year 1976. (Staff Exhibit 45.) For Pacific, the pertinent years and comparable differences are as follows: Test year 1973, 1.52 percentage points; test year ending June 30, 1975, 2; test year ending June 30, 1976, 2.17. (Staff Exhibit 46.) The flow-through basis always produces a higher rate of return because the greater the dollar amount of depreciation differential is between straight-line and accelerated depreciation, the smaller the correlative federal tax expense is for the flow-through company, and the greater the earned rate of return.

While we agee that full flow-through is the proper and best ratemaking method, we shall not consider it further because both Pacific and General would be ineligible for accelerated depreciation and ITC if rates were set on a flow-through basis. We must look to some other alternative, proposed or encompassed in the entire range of possible alternatives.

All the variations on the theme of increasing the deferred tax reserve provide readily estimable items for the pupose of computing the necessary numbes to determine the gross revenue requirements and rates. On the other hand, the reduction in rate of retun is subjective, highly judgmental, and most difficult of quantification, as the parties concede. If we were to adopt reduction in rate of return, what number would we adopt? How is this number to be determined? Is the difference in rate of return because of reduced risk merely a function of the dollar difference, as suggested by LA's witness? (Exhibit 22, page 16.) If

not, what other factors are used to compute the actual number? If we adopt reduction in rate of return based on the dollar differences, as computed by the staff, what justification is used to differentiate this return from the return based no normalization accounting? Do we reason that the entire reduction in rate of return is caused by the risk reduction, as we did in D.85627 (Southern California Gas Company)?

In D.83540, the decision on petition for rehearing in D.83162, we stated on page 4: "The impact of normalization upon risk, and hence upon rate of return, was taken into account in the Commission's deliberations and was one of the factors which caused us to reduce the equity return authorized for Pacific below that authorized for other California utilities of similar capital structure. The impact of normalization on Pacific's risk was not specifically discussed because it was not disputed; all parties, including Pacific, conceded that the authorization of normalization reduces risk below that which would otherwise result. This uncontradicted evidence was taken into account in fixing rate of return." To now say that we shall again reduce rate of return in D.83162 when we already conceded that it was taken into account in setting the original rate of return would be unfair as the reduced risk would be reflected twice in rate of return. We believe it fairer to use a variation of the annual adjustment proposed, which we will call the "averaged annual adjustment".

The theory of this method is simple. Because the increase in the deferred tax reserve is deducted from rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenues will then produce less tax expense since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reduction.

General's expert witness testified (Exhibit 3, page 10): "If the deferred tax reserve is determined as of a time subsequent to the test period, tax expense for ratemaking purposes must be determined as of the same time." This principle is embodied in General's first alternative (pages 13 and 14, above), which remedies the alleged defect of the old pro forma method, which did not take into account tax expense for the same period used to calculate the reserve. (General's opening brief, page 16.) General's opening brief, page 16, describes the methodology, as follows: ". . . the deferred tax reserve is averaged three years into the future in the same fashion as pro forma normalization, and in addition, federal income tax expense is also averaged for the same three-year period by which test period tax expense and rate base is adjusted. The necessary correlation of the reserve and tax expense provided in the cited Treasury Regulation is thereby achieved (Exhibit 3, page 16)." This is exactly the methodology for the averaged annual adjustment.

General believes it fair to asume growth in the tax expense every year. The actual federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it. (Exhibit 36, Pacific; Exhibit 27, General.)[8] TR 1.167(i)-(1)(h)(6) does not discuss revenue growth, nor the direction of federeal tax expense, but only the time frame for two specific items. We think it equally fair to assume a tax expense for the averaged annual adjustment that decreases as the deferred tax reserve increases in each year to accurately reflect only the increase in deferred tax reserve in the same period of tax expense. Thus, we will hold constant all items of cost-of-service not directly dependent on the increase in deferred tax reserve. The computation starts with the test year figures. Using the latest available estimates, we will compute the reduction in net revenues resulting from the increased deferred tax reserve in each of the next three years, compute the resulting decrease in tax expense in each corresponding year, then average the deferred tax reserve and federal tax expense for the four-year period. These averaged annual adjustment figures for deferred tax reserve and federal tax expense will then be used in the current test years for the pending rate cases. For past years, the total of the decrease in net revenues and decrease in federal tax expense[9] will be deducted from the gross revenues computed—under normalization accounting, and the difference shall be refunded. Tables 1 and 2 (Appendices B and C) show the method and results for Pacific

[8] In addition, the effective actual tax rate has been generally declining.
[9] A small factor shall be added as appropriate to compensate for decreased uncollectibles and franchise taxes.

and General, respectively. Total refunds through December 31, 1977 for Pacific are $110,785,000 and for General are $40,230,000. The current rate reduction is $31,609,000 for Pacific and $6,571,000 for General,[10] based on current test years and estimates for three succeeding years. The refund amounts contain interest at the rate of 7 percent per annum through December 3, 1977 from the time the rates were originally authorized and collection began. The deferred tax reserve amounts used are actual through 1976 and estimated thereafter.

Pacific's opening brief (pages 42 and 43) indicates that cost-of-service must include the total tax expense [11] for the test period and the succeeding "pro forma" period This means the tax expense for each of the future years will have to be estimated. While Pacific agrees that the regulations do not cover how tax expense must be estimated, it indicates that the same method used to estimate future deferred tax reserve must be used to estimate future tax expense or the procedure would be suspect and subject to IRS disapproval. No authority is cited nor is any specific method of estimating proposed, nor does the IRS and the treasury regulations direct or discuss the estimating process. We believe our method is direct, simple, and in full compliance with the applicable federal law. Eligibility will be maintained since the federal tax expense for cost-of-service purposes is computed for the same period as the deferred tax reserve. While we agree that it uses a bookkeeping fiction, it is no more fictitious, no more illogical, and no more unreasonable than the fictitious theory of normalizaiton. In *San Francisco* v. *PUC* (1971) 6 C 3d 119, 130–131, the court said "Both of the extreme methods (normalization and flowthrough) involve a fictitious charge of federal tax expense . . . Since a fictitious figure must be used under either method to limit the harsh results insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due processes (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections." We adopt this reasoning here.

The averaged annual adjustment is actually a form of annual ratemaking. It is not objectionable because it uses assumed constants, as these are used in an ordinary test year projection, whether or not we are considering the deferred tax reserve and the tax expense in an isolated manner. If the test year is 1970 and the rates remain in effect until the next test year, which is 1974, we have assumed that the cost-of-service has remained constant for the years 1971, 1972, and 1973. This may be unrealistic, but clearly permissible under our authority and the law. On a normalization basis, we will do the same. We will compute the deferred tax reserve and the tax expense on a normalized basis for the test year, and thereafter until the next test year those items and all other elements of cost-of-service are deemed constant. We see no difference in taking the deferred tax reserve and computing the tax expense and the rates based on those two items (and their variables) for years subsequent to the test year and averaging them back into the test year. Though the method is different, the principle is identical to the ordinary test year principle. Nor is this subject to the objection that this is a flow-through subterfuge. Everything and every method proposed by any party, including normalization as used by the companies here, is a method of flow-through. Normalization, according to Pacific, saves the ratepayers a great deal of money compared to straight-line depreciation, and there is no question that it does. But it does not approach the only sensible and realistic method of setting rates—using the actual tax expense as the cost-of-service tax expense. The method being adopted here is a more equitable and realistic method of normalization than the other proposals and the best available now.

ITC

While we agree with the Supreme Court that the effect of accelerated depreciation and ITC is identical the laws and regulations respecting them differ substantially. Thus, the specific delineation of permissible ratemaking policies in regard to maintaining ITC eigibility as set forth in IRC Section 46, supra, requires a ratemaking treatment for ITC differing from that accorded accelerated depreciation.

There is no question that utilities which did not elect accelerated depreciation with flow-through prior to the effective date of TRA were ineligible to elect Option 3 (immediate flow-through of ITC when it became effective in December, 1971. In D. 85627 (Southern California Gas Company (SoCal)), we imposed a

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[10] This amount may be adjusted for more current estimates in A.55492 for Pacific.

[11] General's exception to the Proposed Report makes this same point. Our discussion applies equally to this exception.

rate of return reduction because of the reduced risk and increased cash flow generated in part as a result of SoCal's election of Option 2 for the years 1975 and 1976, when ITC was increased for those years from 4 to 10 percent for utility plant additions and from 7 to 10 percent for transmission plant additions.[13] It is our position that ITC eligibility was not affected by D. 85627. However, the Internal Revenue Service (IRS), in response to a request from SoCal, issued an alleged ruling (Exhibit 52) of which we were notified by letter dated November 22, 1976. In this alleged ruling the IRS concludes that ITC will not be available to SoCal for federal income tax purposes when the benefits to be derived therefrom are treated for ratemaking purposes in the manner provided in D. 85627 (as affirmed by D. 86117). Our Supreme Court has granted a writ of review on SoCal's appeal of D. 85627 and 86117 and has heard oral argument on the matter. While the IRS ruling is not the final determination of this issue, we believe that a rate of return reduction is not warranted in this proceeding in any event. We also, in this proceeding, reject the concept of a permanent reduction in rate of return for past as well as future rates, as recommended by some of the parties.

We do not believe a rate of return reduction to be any more of a subterfuge for accomplishing flow-through than any of the other methods presented here nor are we rejecting it for that reason. In a full rate case, all the elements of cost-of-service are considered in the process of arriving at a reasonable rate of return. Here, all the parties advocating this method base it solely on the number of dollars of desired refund, and not vice versa. In this proceeding, where we are addressing ourselves to changes in the level of ITC which may be expected to occur beyond the test year, we prefer a more precisely ascertainable result.[13] For these reasons we are adopting for the purposes of ITC and eligibility thereunder the only method that appears to encompass all the factors we desire, the annual adjustment. Sometime prior to the first day of each year after (and including) the test year, we shall recalculate the ITC for the coming year on the basis of the best estimates then available and shall adjust the rates accordingly at the beginning of the year to provide for the full year-to-year growth in the annual amount of ratable flow-through (Option 2). The difference in tax expense between that occurring on the test year because of Option 2 and that estimated for the adjustment year would be computed on the most recent estimate for eligible plant additions. The intrastate factor would be applied and the charge would be converted to revenue requirement by the proper net-to-gross multiplier and applied as an adjustment to decision rates for the year following the test year. Thereafter, we shall delete the earliest year and use the next year to establish the tax expense difference, and adjust the then current rates.[14] For Pacific, the refund obligation through December 31, 1977 for ITC is $51,231,000 and the approximate current rate reduction is $23,346,000 (Table 3, Appendix D). For General, the comparable figures are $15,649,000 (gross) and $4,771,000 (Table 4, Appendix E).

We are rejecting all the other proposed treatments for varying reasons, principally that they either cause or tend to raise doubts about eligibility, or do not adequately redress the balance between the ratepayers and the utilities.

Imputed flow-through of accelerated depreciation

In reviewing the record of this proceeding it has come to our attention that certain old vintage plant additions were not previously considered in the ratemaking process. We shall discuss Pacific and General separately.

Pacific

In D. 74917 dated November 6, 1968 we imputed flow-through of accelerated tax depreciation for 1967 vintage plant using a 1967 test year. In D. 77984 dated November 24, 1970 (test year 1970) the normalization treatment for accelerated depreciation was ordered for Pacific. When this decision was annulled the rates reverted to those set in D. 74917 (test year 1967). In D. 80347 dated August 8, 1972 rates were increased using 1970 vintage plant additions to determine the flow-through of accelerated depreciation ordered there. The rates set in this final decision were effective until August 17, 1974, the effective date of the rates

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[13] This increase in ITC was extended through 1980 in the bill signed into law on Oct. 4, 1976.

[13] This reasoning applied equally to accelerated depreciation.

[14] Annual adjustments may also be implemented when a Commission decision becomes effective after the beginning of the first annual adjustment period. The first annual adjustment will merely be incorporated in any such decision.

set in D. 83162. The net effect of this history is that no accelerated depreciation for 1968 and 1969 vintage plant additions was ever reflected in Pacific's rates, even though our Supreme Court approved the imputed flow-through of accelerated depreciation.

In Exhibit 32 in A. 53587 (and the A. 51774 rehearing), this imputation was proposed for the two years in question. We shall adopt this recommendation. Further, we shall continue this imputation through Pacific's test years 1973 in D. 83162 and 1974–1975 in D. 85287 and shall order here an ongoing reduction in pending A. 55492 (test year 1975–1976) for this flow-through item. These amounts are as follows:

Flow-through of 1968 and 1969 vintage plant additions (Table 5, Appendix F)

[Dollars in thousands]

D. 83162 (test year 1973) August 17, 1974 to January 14, 1976	$24,158
D. 85287 (test year 1974–75) January 5, 1976 to December 31, 1977	19,412
Total	43,570
Ongoing reduction (TY 1975–76) A. 55492	5,539

Summary of Pacific Refunds and Rate Reductions Through December 31, 1977

[Dollars in Thousands]

Refunds:	
Accelerated Tax Depreciation (Table 1, Appendix B)	$110,785
ITC (Table 3, Appendix D)	51,231
Flow-Through of 1968 and 1969 vintage (Table 5, Appendix F)	43,570
Total refunds	205,586
Rate Reductions (A.55492):	
Accelerated Tax Depreciation (Table 1, Appendix B)	31,609
ITC (Table 3, Appendix D)	23,346
Flow-Through of 1968 and 1967 Vintage (Table 5, Appendix F)	5,539
Total rate reductions	60,494
Total refunds and rate reductions	266,080

General

A similar situation exists for General but it is limited to 1969 vintage plant additions. In D.75873 dated July 1, 1969 we imputed flow-through of accelerated depreciation for 1968 vintage plant using a 1968 test year. In D.79367 dated November 22, 1971 increased rates were ordered using the normalization treatment of accelerated depreciation beginning with 1970 vintage plant additions. Thus, 1969 vintage plant additions were never reflected in General's rates, all of which have been subject to refund since D.79367.

In Exhibit 5–R in A.53935 (and the A.51904 rehearing), this imputation was proposed for 1969. We shall adopt this recommendation and shall continue this imputation from December 12, 1971 (the effective date of D.79367) through test years 1970 (D.79367), 1974 (D.83779), and 1976 (D.87505).

However, in Table 6 of Exhibit 2, General claimed credit for refunds and rate reductions already made as a result of the annulment of D.78851 of Pacific.[15] In D.83778 dated November 26, 1974 we said, on page 41:

"The refunds already made by General are attributable to the annulment of Decision No. 78851 while the settlement revenue losses to General are attributable to the annulment of that decision and also to the difference between Pacific's rates authorized in Decision No. 80347 and Pacific's annulled rates."

Failure to give General credit for these sums would amount to requiring refunds. Since this would be inequitable, we are offsetting the losses already incurred against the refunds and rate reductions required of General by this decision.[16]

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[15] This claim was also made in General's exceptions to the Proposed Report.

[16] In applying the credit, reductions are treated separately for 1971, 1972, and 1973 (from 1/1/73 to 9/22/73 only) and compared to refunds computed for those years, in accordance with the principle used by General in Exhibit 2, Table 6. Reductions in refunds are made first to the imputed flow-through refunds, then any remaining reduction is credited to ITC, and finally any remaining reduction is credited to accelerated tax depreciation. (See Table 7, Appendix H.)

Summary of general net total refunds and rate reductions through Dec. 31, 1977

	Thousands
Refunds:	
Accelerated tax depreciation (table 2, app. C)	$34,987
ITC (table 4, app. E)	15,363
Flow-through of 1969 vintage (table 6, app. G):	
a. D.79367 (TY 1970) Dec. 12, 1971 to Dec. 20, 1974	9,244
b. D.83779 (TY 1974) Dec. 21, 1974 to July 17, 1977	7,245
c. D.87505 (TY 1976) July 18, 1977 to July 31, 1977	670
Total refunds	65,440
Rate reductions (D.87503):	
Accelerated tax depreciation (table 2, app. C)	6,571
ITC (table 4, app. E)	4,771
Flow-through of 1969 vintage (table 6, app. G)	1,311
Total rate reduction	12,653
Total refunds and rate reductions	78,093

Service

Pacific has depicted a service and employment scenario of horrendous proportions in the event it loses eligibility for accelerated depreciation and ITC, and assuming a back tax payment of $764 million, rate refunds of $73 million and an ongoing rate reduction of $62.6 million. In 1972 and 1973, however, Pacific refunded $176 million together with a rate reduction of $90 million and had no significant employee layoffs, no deterioration in service and no adverse effects on earnings.

Because the eligibility of both companies is unaffected in our judgment, we foresee no meaningful change in the operations and quality of service, number of employees, level of earnings, impairment of financial integrity, or other deleterious consequences as predicted by Pacific. Thus, the companies are put on notice that any deviation from their current service indices, objectives, standards, and our General Order No. 133 shall be monitored and, when appropriate, punished to the fullest extent of the law. For these purposes, we particularly emphasize Pacific's 1976 Service Objective List admitted as Exhibit 43 in its pending A.55492 as exemplary of the service standards expected, together with the ultimate determination, in the same proceeding, of the acceptable level of held primary orders.

Miscellaneous contentions

Pacific and General have discussed many other points, some pertinent, some not. We shall briefly discuss due process, actual results of operations, confiscatory rates, retroactive ratemaking, credit for revenues authorized but uncollected, and settlement adjustments.

Pacific relies heavily on the case of *West Ohio Gas Company (No. 2)* v. *Public Utilities Commission* (1935) 294 US 79. There the regulatory agency had, in setting a rate in 1933, chosen to rely exclusively on data from 1929, ignoring available revenue and expense data from 1930 and 1931. The court said this was an unconstitutional procedure. Our situation here is easily distinguishable, as we are taking into account the actual deferred tax reserve and ITC amounts for the past years and computing the functional variables from that actual number. Our Supreme Court in *Los Angeles* v. *PUC* (1975) 15 C 3d 680, has already found this procedure to be proper since the tax expenses and reserves under accelerated depreciation vary abnormally with respect to the other components of a utility's finances. The court said on page 703, "Simply to recognize this fact is not to deny due process."

Further, the actual results of Pacific's operations indicate a financial picture much brighter than depicted by Pacific. It is true that the dividend on common stock has not been increased since 1961, as Pacific alleges, but that is a management decision which is not directly related to its per share earnings or any other indicia of financial progress. In 1961 Pacific had 104 million common shares outstanding while at the end of 1975 it had over 168 million such shares and contemplates over 181 million at the end of 1976. Thus, the total dividends paid now are approximately two-thirds greater than in 1961, to over $202 million in 1975. Further, the earnings per share increased from $1.46 in 1970 to $1.82 in 1975 and $2.06 in 1976, all on an increased number of outstanding shares. There has been

an increase in the number of employees, an increase to earned surplus from 1972 to 1975 of the staggering sum of $245 million, and an increase in construction budget from 1971 to 1974 of $225 million. And this was all accomplished while refunding $176 million with an ongoing rate reduction of $90 million per year. If this be confiscation, let there be more of the same. In view of these facts, Pacific's arguments regarding confiscatory rates are untenable and rejected.

Neither do we agree with Pacific's position that the imposition of a penalty for imprudence would constitute improper retroactive and punitive ratemaking since this procedure has already been approved by the Supreme Court (6 C 3d 119). Penalties for imprudence, like penalties for civil or criminal wrong, have nothing to do with rates; they are punishment. But we are not imposing a penalty here; we are determining the proper basis for setting rates.

Pacific has suggested that it is appropriate, in the event the Commission orders a refund in this matter, to deduct from the amount of refund the revenues previously authorized but not collected because it has failed to earn its authorized rate of return. If rate of return has not been earned, the remedy for that, as clearly set forth by the court in 15 C3 680, is to seek rate relief, which both companies have done and are presently doing. Further, this recommendation would guarantee the authorized rate of return. Because it is axiomatic that this Commission does not guarantee the rate of return, but merely provides an opportunity to earn it, the requested credit would be inapposite.

Since our action will not render Pacific ineligible, we need not answer its argument that this would unduly burden interstate commerce, particularly as no evidence on this point was tendered.

The rates to be filed by the utilities pursuant to this order will, of course, reflect settlement payments between utilities. However, we will not authorize any retroactive settlement adjustments associated with refunds resulting from this order.

Refunds in the Form of Stock

It was suggested in the event a refund was ordered that it be accomplished via the issuance of capital stock of Pacific and General. The companies introduced a great deal of material setting forth the problems involved with this idea. The major potential problems are with the Securities & Exchange Commission, the difficulty of issuing minute fractional shares for small refunds to ratepayers, the large cost of such a program, and the Commission's authority to order such a securities issue. No party supported this concept in its present form. We shall not order it.

Refunds and Reductions

Refunds in the past have been made in direct proportion to the billing of the various customers without regard to class of service. In this case it was suggested that refunds be made only to residential customers on the theory that since business customers include telephone service cost as part of their cost of doing business, they are being paid by the consumer for the cost of the phone service. A refund theoretically would then create a windfall for the business phone customers since no refunds by the business customers would be made to its customers. It can also be argued, however, that the amount of any refund to the business customer would be used to reduce the cost of business for the period in question and thereby would be reflected in lower or stable prices. In our opinion there is no evidence, one way or the other, in this proceeding to support either view.

Another suggestion was to refund to all customers on a per capita basis, meaning that the total amount of the refund would be divided by the total number of customers of the company and the same dollar amount refund would be given to each customer whether residential or business. Since the number of residential customers is much greater than business customers, and as residential revenues approach 50 percent, it is apparent that individual business customers on average pay much greater monthly revenues to the phone companies than the individual residential customers. This proposal, for example, would have the effect of giving the city of Los Angeles, General Motors, and every individual the same amount of refund. In the case of the residential customers, their refunds might well exceed their monthly bills.

Pacific and General will be directed to file proposed refund plans. Approval, disapproval, or modification of the proposed plans will follow by subsequent Commission order.

The ongoing prospective rate reductions ordered herein shall be reflected in rates for all current subscribers by a uniform proportional reduction in the recurring basic exchange primary service rates. To insure that rates for competi-

tive services are not reduced (since those rates are generally priced as nearly as possible at full cost) we are directing that only rates for basic exchange primary service be reduced. With respect to central office centrex service the reductions shall be made on the trunk rate per station.

IRS Ruling Request

The companies have suggested that any proposed action changing the method of normalization now being used should allow the continuance of existing rates, either by putting the rates aside in a trust fund, as suggested by the Supreme Court, or keeping them subject to refund as at present, until such time as a ruling can be rendered by the IRS regarding the retention of eligibility under the method adopted by this Commission for treating the tax expense problems. This is based on the theory that if the IRS disapproves the proposed treatment the present method of accelerated depreciation shall continue in effect, or another proposed method may be submitted for a ruling. But the companies' requests provide no incentives to obtain an expeditious advance IRS ruling, and might lead to further delay in the implementation of the refunds contemplated in this order. Moreover, General's expert witness Nolan indicated that there are some instances where the IRS will not issue an advance ruling, nor does the IRS necessarily advise in advance that it will not issue such a ruling. The supplicant merely waits and hopes. Nolan also said that the more difficult the problem, the more likely the IRS is to avoid issuing an advance ruling. We have here a case of first impression under the tax laws, and we think an advance ruling within a reasonable time is not probable. Moreover, the opportunities for such action by the utilities have been ample in the past, yet they took no such action. For these reasons we think that their proposals are inappropriate.

Exceptions to Proposed Report

We shall discuss here, where necessary, the exceptions that have not been discussed elsewhere in this opinion.

Pacific

Pacific's exceptions generally fall into two categories:

1. Since D.83162 was issued in August 1974, its earnings have been below the authorized rate of return and it is improper to order refunds and rate reductions in such circumstances. We have already discussed this point elsewhere, and concluded otherwise. There is nothing sufficiently meritorious in Pacific's exceptions in this area that have not been raised, discussed, and disposed of by this Commission, or our Supreme Court.

2. Pacific's eligibility for accelerated tax depreciation and ITC is endangered by the proposed treatment of these benefits.

(a) *Accelerated Tax Depreciation.* Pacific complains of the use of recorded data for historical periods, but in its brief cited the *West Ohio Gas* case (supra) as requiring the recognition of such data. Its position is inconsistent and varies with the direction the wind is blowing. Fnrther, there is no prohibition in proper ratemaking or the IRC sections in question which bar this procedure.

Pacific also complains of the failure to nse the pro rata requirements in Treasury Regulation 1,167(l)-1(h)(6)(ii). It overlooks the discussion on page 3 of Exhibit 16 sponsored by staff witness John Quinley, where the use of the pro rata percentage of 46.33 is shown. Mr. Quinley explains the offsetting working cash adjustment which produces a combined effect of 50 percent as the proper figure to be used in determining the average deferred tax reserve and its ultimate revenue effect. Footnote 4, Table 1, Exhibit 16, reflects this combined effect, as does Footnote 4, Table 1, Exhibit 10-A (sponsored by Pacific), which uses the identical percentage as its Table 1 is identical to Table 1 of Exhibit 16.

The other exceptions with respect to accelerated depreciation have been either mentioned or explained elsewhere and merit no further discussion.

(b) *Investment Tax Credit.* Pacific cites proposed treasury regulations allegedly relating to its interpretation of our ITC treatment. These proposals in our judgment do not effect the validity of our treatmeut and have no force or effect, in any event, being mere proposals. We reiterate that our treatment of ITC is akin to an annual ratemaking procedure. We see nothing in law or logic that prohibits this treatment.

General

The thrust of General's exceptions relates to the alleged ineligibility for accelerated depreciation which would occur as a result of the treatment of that subject in the Proposed Report. General alleges that the total tax expense must

be considered for the same period for which the deferred tax reserve is estimated, and the Proposed Report considers only the reduction in tax expenses. This is not the case, as the reduction in tax expense for years after the test year is used to reduce the test year tax expense used in the succeeding year. The effect is to reduce each succeeding year's tax expense, but the entire tax expense is used for the appropriate period. General also alleges that the proposed method is exactly like the old pro forma method, except for the time period. That is correct, because the failure to consider the deferred tax reserve for the same period as the tax expense is the alleged defect of the old pro forma method regarding eligibility. The Averaged Annual Adjustment remedies this defect by considering the two required items separately for the same period. While the effect is the same as pro forma, we are specifically complying with the existing tax laws by using a proper method to compute the revenue requirement. It must also be noted that this method complies exactly with the method (though not the assumptions) recommended by General and its witnesses.

We have already discussed and decided the other major exception: the double refund effect for revenues authorized but not collected because of Pacific's prior refunds.

There is no retroactive ratemaking involved here since all General's rates since November 22, 1971 have been subject to refund. The fact that ITC was not previously considered does not make it res adjudicata, nor does it prevent this Commission from reflecting its effect where possible. That is what we are doing by this decision.

LA

LA objects to the failure of the Proposed Report to decide the constitutionality of the relevant tax laws under the Tenth Amendment to the U.S. Constitution. We already decided that question in the affirmative in D.83778 and see no reason to go into the matter again.

We have previously discussed, directly or indirectly, all the other matters raised in L.A.'s exceptions.

TURN

TURN filed two exceptions, one relating to its proposed method of determining the amount of refunds (discussed earlier), and the other relating to the effective date of the Proposed Report. We see no need to consider its exceptions.

Epilogue

We desire to discuss the wisdom of using the tax laws for the purpose of providing a capital subsidy (in this instance, phantom taxes) from the taxpayers (in this instance, the ratepayers) to a special interest group (in this instance, state-regulated utilities). This occurs because every dollar of taxes that the utilities pay is obtained in rates from the ratepayer, even when the utilities can defer, and perhaps never pay the taxes collected in rates. The regulators must essentially order two dollars to be paid to the utility by the ratepayer for each dollar in taxes avowedly to be paid by the utility. This seems to us to be a wasteful use of resources as well as a legally sanctioned subsidy to the utility from the ratepayer without the latter's consent. The money is not being contributed by investors in the usual manner, but is being contributed in the form of rates by the ratepayer on a two-for-one basis and not on a one-for-one basis, as is the case for traditional investment capital. The funds are being obtained from the ratepayers under the guise of taxes, while Congress has decreed that the money so collected as taxes need not be used as taxes by the utilities, but may be used by the utilities for whatever purposes they desire. There is no restriction on the use of these funds in the tax laws. The taxes collected, but not paid, in essence amount to a direct capital subsidy which the utilities may use as unrestricted capital. Nothing is paid to the ratepayers for this investment use of the ratepayers' money as would be paid to traditional investors. Thus, this is free capital, and this is occurring in a free enterprise system which traditionally rewards venture and investment capital!! Here, the converse is true.

The ratepayers are actually being penalized instead of being compensated for this subsidy. Their money is being involuntarily contributed on a two-for-one basis, and no return is forthcoming on any basis. We think this is grossly unfair and should be more forcefully presented by the utilities, by the regulatory agencies, and by consumer organizations. Congress has created a situation where in California both the utilities and the ratepayers feel they are being whipsawed by these tax laws and the actions of this Commission in attempting to be fair to all sides. This Commission believes that it has a legal duty to balance the

interests of the utilities and the ratepayers and is attempting to do so, but finds itself more frequently hamstrung by the actions of Congress where it appears that the interests of the utility ratepayers are not adequately considered, for whatever reason.

What this Commission proposes and strongly supports, in lieu of this hidden subsidy and no-cost capital contribution to the utilities by the ratepayers (we mean at no cost to the utilities), is the elimination of the income tax upon regulated utilities to be replaced with a gross receipts tax (or, for energy and water utilities, a per unit of consumption tax), as a surcharge to all billings paid by the ratepayers, to be collected by the utilities and paid directly to the IRS. This surcharge would be indicated as such on the utility bills and would not be included in the utility cost-of-service. It could easily be structured to provide revenues to the treasury equivalent to that now being paid as income taxes by the utilities. It would eliminate the ratepayers' involuntary and hidden subsidy to the utilities because what they pay in gross receipts tax is what the IRS gets on a dollar-for-dollar basis. If the utilities desire to obtain funds from the ratepayers for the purpose of expansion and investment, let it be done forthrightly by direct subsidy so the ratepayers will have knowledge and the opportunity for input. Let the ratepayers share in whatever benefits might accrue to the utility as the result of any such investment by the ratepayers. We see no reason why the ratepayers, in their role of capital investors, should not share in the fruits of their investment. We believe the tax laws are not the proper medium for the creation of involuntary investment capital. Tax law gimmickry should not tilt or distort the balance necessary between state-regulated utilities and ratepayers.

The gross receipts tax would simplify the job of Congress in levying taxes and simplify the job of the regulatory agencies in setting rates, while preserving the rights of both the utility and the ratepayers. It would create faster rate relief on the part of regulatory agencies and maintain the utilities on a solid financial basis, instead of requiring everyone involved in setting rates to go through a series of contortions and distortions to attempt to comply with or legally avoid the effect of the existing tax laws and the concomitant uncertainty and delay.

Findings

1. Pacific and General were imprudent in failing to select accelerated depreciation when that option was available under the federal tax laws. This imprudence denied the companies the option to elect flow-through accounting for ITC and accelerated depreciation purposes.

2. Flow-through of the tax benefits accruing under accelerated depreciation and ITC is the best method of handling these benefits for the purpose of balancing the interest of the ratepayers and the companies for ratemaking purposes.

3. Pacific and General are ineligible to elect flow-through accounting for accelerated depreciation and ITC for ratemaking purposes pursuant to IRC Section 167, et seq. and Treasury Regulation 1.167, et seq. Normalization accounting is the most appropriate method available to Pacific and General. Under the normalization method we are adopting for ratemaking purposes, tax depreciation expense for ratemaking purposes will be computed on a straight-line basis while federal taxes will be computed on an accelerated depreciation basis. The difference between the two tax computations will be accounted for in a deferred tax reserve. The average sum of the test year deferred tax reserve and the deferred tax reserve for the three next subsequent years shall be deducted from rate base in the test year. As a result of each of the deductions from rate base federal tax expense will be recomputed on the same basis in the test year for the test year and the three corresponding subsequent years, thus matching the estimated tax deferral amount for each period with the estimated federal tax expense for the same period. This method complies with Treasury Regulation 1.167(L)(1), (h)(6) and is normalization accounting.

4. ITC we shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of ITC estimated for the next immediate future calendar year as compared to the last test year (or last preceding year), and recomputing federal tax expense and gross revenue requirements based on that new estimate for each year between rate cases. This method complies with the requirements of ratable service life) flow-through selected by the utilities under IRC Section 46.

5. The methods described in Findings 3 and 4 are an attempt to more accurately reflect in rates the abnormal growth in these reserves compared to the other components of cost-of-service used in computing rates.

6. The methods adopted in this order as described in Findings 3 and 4 comply with the mandate of the California Supreme Court set forth in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680.

7. The methods described in Findings 3 and 4 fairly balance the interests of the ratepayers and the utilities and avoid harsh results to either as a result of the tax benefits accruing under accelerated depreciation and ITC.

8. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 3 for accelerated depreciation is $110,785,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 1. The current rate reduction under this method is $31,609,000.

9. The gross amount to be refunded by General to its ratepayers under the method described in Finding 3 for accelerated depreciation is $40,230,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Tables 2 and 7. The current rate reduction under this method is $6,571,000.

10. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 4 for ITC is $51,231,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 3. The current rate reduction under this method is $23,346,000.

11. The gross amount to be refunded by General to its ratepayers under the method described in Finding 4 for ITC is $15,649,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 4. The current rate reduction under this method is $4,771,000.

12. The maintenance of eligibility under the federal tax laws to allow Pacific and General to use accelerated depreciation and ITC is beneficial to both the ratepayers and the utilities and is an important goal of this Commission in this decision.

13. It is reasonable to order a uniform proportional reduction in the recurring basic exchange primary service rates. With respect to central office centrex service it is reasonable to make the reductions on the trunk rate per station.

14. It is reasonable to impute flow-through of 1968 and 1969 vintage plant additions for Pacific and 1969 vintage plant additions for General, as the Supreme Court has previously approved this procedure in *San Francisco* v. *PUC* (1971) 6 C 3 119, and accelerated depreciation of these vintages has never been reflected in rates.

15. A gross receipts tax surcharge would abolish the "two-for-one" collection of income taxes from the ratepayers in rate setting for utilities and would allow lower utility rates since the gross receipts tax would allow a dollar-for-dollar collection of taxes paid by the utilities to the federal government.

16. As long as plant investment of the utility continues to expand, the deferred tax reserve is actually a tax saving and not a tax deferral.

17. It is unfair and unreasonable to use the tax laws to create investment dollars flowing from the ratepayers to the utilities on which the ratepayers do not receive any return.

18. The gross receipts tax surcharge would eliminate the involuntary capital contribution incurred by the ratepayers and would abolish the windfall to the utilities by allowing them to collect taxes from the ratepayers which they may never have to pay.

19. The investment tax credit is a tax saving and not a tax deferral.

20. A gross receipts tax surcharge will prevent the distortion of the tax laws to create subsidies from the ratepayers to the utilities in the setting of rates.

21. In computing the refunds and rate reductions computed herein, this Commission has used recorded figures, where available, for the periods in question.

22. The reduction and refunds of rates authorized by this decision are justified and reasonable, and the present rates as they differ from those prescribed therein, are for the future unjust and unreasonable.

23. No revenue adjustments for settlements by Pacific and General with interconnecting carriers will be allowed for the refund period.

24. The amount to be refunded by Pacific to its ratepayers pursuant to Finding 14 is $43,570,000, including interest at 7 percent per annum from the date of the respective order entered from which refunds are being required, as set forth in Appendix F. The current rate reduction under this method is $5,539,000.

25. Because of revenues authorized, but not collected, General is entitled to credit for certain sums refunded and lower rates set due to *San Francisco* v. *PUC* (1971) 6 C 3 119 and D.78851 of Pacific. It is reasonable to offset these amounts

against the other refunds required herein, on an annual basis only, first reducing the imputed flow-through of accelerated depreciation under Finding 14, then the ITC refund, and lastly, the accelerated tax depreciation refund.

26. The net amount to be refunded by General to its ratepayers, pursuant to Findings 14 and 25, is $17,159,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Appendix G. The current rate reduction under this method is $1,311,000.

27. As a result of Finding 25, the refunds due from General, pursuant to Findings 9 and 11, are reduced to the net sums of $34,453,000 (Finding 9) and $13,828,000 (Finding 11).

28. The total net refunds due from Pacific and General, and the total current and/or ongoing rate reductions required respectively, are summarized in the tables contained on page 32 (for Pacific) and page 34 (for General).

CONCLUSIONS

1. The methods described in Findings 3 and 4 maintain the eligibility of the utilities to use accelerated depreciation and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General.

2. This Commission does not guarantee the utility the rate of return authorized in rate proceedings, but merely provides an opportunity to earn that return.

3. The method described in Finding 3 for accelerated depreciation for Pacific and General is a normalization method of accounting.

4. The method contained in Finding 4 for ITC complies with the ratable (service life) flow-through option of ITC under IRC Section 46.

5. The imputation of flow-through of the accelerated depreciation benefits for 1968 and 1969 vintage plant additions for Pacific and 1969 vintage plant additions for General is a proper ratemaking procedure and does not affect eligibility under the TRA of 1969.

6. The rates being set herein are not confiscatory.

7. The offset allowed General due to the revenues authorized, but not realized, is a proper ratemaking procedure.

8. There is no retroactive ratemaking ordered in this decision.

ORDER

It Is Ordered that:

1. The Pacific Telephone and Telegraph Company shall refund the sum of $205,586,000 (computed as of December 31, 1977), being the total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and accelerated depreciation for 1968 and 1969 vintage plant addition on a flow-through basis, as determined herein pursuant to Findings 3, 4, and 14. This amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

2. General Telephone Company of California shall refund the sum of $65,440,000 (computed as of December 31, 1977), being the net total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined herein pursuant to Findings 3, 4, 14, and 25. This amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

3. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file refund plans for all current (at the time of filing of the plan) subscribers. This plan shall be filed within thirty days after the effective date of this order. This plan must be approved by an order or resolution of the Commission.

4. The methods described in Finding 3, 4, and 14 shall be applied to all future rates of The Pacific Telephone and Telegraph Company and General Telephone Company of California.

5. The filings required for the continuous surveillance of earned rate of return as previously ordered in D.83540 and D.83778 are no longer required.

6. The Pacific Telephone and Telegraph Company shall reduce current rates by the sum of $60,494,000 (computed as of December 31, 1977), being the total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and

accelerated depreciation for 1968 and 1969 vintage plant additions on a flow-through basis, as determined herein pursuant to Findings 3, 4, and 14.

7. General Telephone Company of California shall reduce current rates by the sum of $12,653,000 (computed as of December 31, 1977), being the net total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined pursuant to Findings 3, 4 14, and 25.

8. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file tariffs reflecting such reductions on a uniform proportional basis on recurring basic exchange primary service rates, and with respect to central office centrex service the reductions shall be made on the trunk rate per station. Such tariffs shall be filed within thirty days after the effective date of this order and shall not become effective until approved by order or resolution of this Commission.

9. Pacific and General shall not recompute intercompany EAS or other settlement amounts between themselves or with other independent companies as a result of the refunds or rate adjustments ordered herein except for business done on or after the effective date of this order.

10. In the event the refund plans and tariffs required to be filed by this order are effective after December 31, 1977, the amounts shown in Ordering Paragraphs 1, 2, 6, and 7 shall be recomputed to the appropriate effective date of the refund plan or tariff filing, with interest as computed in Ordering Paragraphs 1 and 2.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 13th day of September, 1977.

I will file a dissent.

ROBERT BATINOVICH,
President.

(Signed) WILLIAM SYMONS, Jr.,
Commissioner.

I will file a concurrence.

(Signed) RICHARD D. GRAVELLE.
RICHARD D. GRAVELLE,
CLAIRE T. DEDRICK,
Commissioners.

I will file a written dissent.

(Signed) VERNON L. STURGEON,
Commissioner.

Certified as a true copy of the original.

Assistant Executive Director,
Public Utilities Commission,
State of California.

APPENDIX A

LIST OF APPEARANCES

Applicants: Robert M. Rails and Robert Dalenberg, Attorneys at Law, for The Pacific Telephone and Telegraph Company; John Robert Jones, A. M. Hart, and H. Ralph Snyder, Jr., Attorneys at Law, for General Telephone Company of California.

Interested Parties: Thomas M. O'Connor, City Attorney, and Robert Laughead, for City and County of San Francisco; Robert W. Russell and Manuel Kroman, for Department of Public Utilities & Transportation, City of Los Angeles; George R. Gilmour, Attorney at Law, for TURN; James F. Crafts, Jr., Attorney at Law, and Del Williams, for Continental Telephone Company; Louis Possner, for City of Long Beach; John W. Witt, City Attorney, by William S. Shaffran, Deputy City Attorney, for City of San Diego; Alexander Googoian, City Attorney, for City of Bellflower; Burt Pines, City Attorney, by Leonard L. Snalder, Deputy City Attorney, for City of Los Angeles; Jack Krinsky, for Ad Visor, Inc.; Dina G. Beaumont, for Communications Workers of America; Thelma Garcia, for Pacific Telephone Women Employees for Affirmative Action; Joseph J. Salazar, for Los Padrinos, Inc.; William M. Bennett, Attorney at Law, for Cousumers Arise Now, and himself; Diamantes P. Katsikaris, for Independent Taxpayers Union of California, Inc.; Timothy J. Sampson, for Citizens Action League; and John Mack, by Ballard W. Brooks, for Los Angeles Urban League.

Commission Staff: Timothy Treacy, Attorney at Law, J. D. Quinley, and K. K. Chew.

APPENDIX B

TABLE 1.—PACIFIC TELEPHONE & TELEGRAPH CO. INTRASTATE OPERATIONS—COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

[Dollar amounts in thousands]

Test year	Depreciation differential [1]	Federal tax effect [1]	Average reserve for deferred taxes [1]	Net revenue reduction			Federal income tax reduction [5]	Other gross revenue effects [6]	Gross revenue reduction over normalization [7]	Refunds by decision and years rates effective	
				Normalization [2]	Average annual adjustment [3]	Additional net reduction [4]				Year	Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
1973	$148,963	$71,502	$136,787	$12,106	$24,418	$12,312	$11,364	$480	$24,156	1974	[9] $11,501
										1975	[9] 30,623
										1976	[9] 356
1974–5	[12] 207,825	99,756	[12] 267,925	23,711	38,687	14,976	13,823	644	29,443	1976	[10] 33,836
										1977	[10] 34,469
Total refunds through Dec. 31, 1977											110,785
1975–6	[12] 235,807	113,187	[12] 374,396	33,134	49,212	16,078	14,840	691	31,609	1978	[11] 31,60
Annual ongoing reduction in excess of normalization											31,609

[1] Exhibit 10–A, table 1, cols. (A) and (D). Tax at 48 percent of col. (A).
[2] Exhibit 10–A, table 2, normalization divided by NTG (1.962 for 1973 and 1.966 for other test periods).
[3] Exhibit 16–A, table 2–A, col. (B) divided by NTG.
[4] Col. (E) minus col. (D).
[5] Col. (F) times 0.92307 [(F) times 0.48/1 minus 0.48].
[6] Effects of State income tax and uncollectibles (0.039 times col. (F) for T.Y. 1973 and 0.043 times col. (F) for T.Y. 1974–75 and 1975–76).
[7] (F) plus (G) plus (H).
[8] Col. (I) adjusted as per exhibit 34, p. 4 and exhibit 41. Interest added at the rate of 7 percent per year for 1974–77.
[9] D.83162 rates effective Aug. 17, 1974 to Jan. 4, 1976.
[10] D.85287 rates effective Jan. 5, 1976.
[11] A.55492 test year data adjusted to most recent estimates.
[12] Average of 2 calendar years.

APPENDIX C

TABLE 2.—GENERAL TELEPHONE CO. OF CALIFORNIA INTRASTATE OPERATIONS—COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

[Dollar amounts in thousands]

Test year	Depreciation differential [1]	Federal tax effect [2]	Average reserve for deferred taxes [1]	Net revenue reduction: Normalization [3]	Net revenue reduction: Average annual adjustment [3]	Net revenue reduction: Additional net reduction [4]	Federal income tax reduction [5]	Other gross revenue effects [6]	Gross revenue reduction over normalization [7]	Refunds by decision and years rates effective: Year	Refunds by decision and years rates effective: Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
1970	$3,565	$1,711	$856	$71	$1,621	$1,550	$1,431	$255	$3,236		
										1971	([12])
										1972	([12])
										1973	[9] $5,398
										1974	[9] 5,203
1974	45,881	22,023	65,669	5,812	8,797	2,985	2,755	594	6,334	1974	[10] 230
										1975	[10] 7,986
										1976	[10] 8,052
										1977	[10] 4,255
1976	47,519	22,809	110,507	9,780	12,865	3,085	2,848	638	6,571	1977	[11] 3,329
Total refunds through Dec. 31, 1977											34,453
										1978	[11] 6,571
Annual ongoing reduction in excess of normalization											6,571

[1] Exhibit 2, table 1, cols. (A), (B), and (D).
[2] Exhibit 2, table 2, normalization divided by NTG (2.087 for T.Y. 1970 and 2.113 for T.Y. 1974 and 1976).
[3] Exhibit 6–A, table 2–A, col. (B) divided by NTG.
[4] Col. (E) minus col. (D).
[5] Col. (F) times 0.92307 [(F) times 0.48/1 minus 0.48].
[6] Effects of State income tax and uncollectibles (0.1645 times col. (F) for T.Y. 1970, 0.1990 times col. (F) for T.Y. 1974 and 0.20695 times col. (F) for T.Y. 1976).
[7] (F) plus (G) plus (H).
[8] Col. (I) adjusted as per exhibit 25, table A–A–2. Interest added at the rate of 7 percent per year for 1971–77.
[9] D.79367 rates effective Dec. 12, 1971 to Dec. 20, 1974.
[10] D.83779 rates effective Dec. 21, 1974 to July 17, 1977.
[11] D.87505 rates effective July 18, 1977. Test year data adjusted to most recent estimates.
[12] Adjustments for revenues not collected are shown on table 7.

APPENDIX D

TABLE 3.—PACIFIC TELEPHONE AND TELEGRAPH CO. INTRASTATE OPERATIONS—COMPUTATION OF REFUNDS AND 1978 REVENUE DEDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

[Dollar amounts in thousands]

Test year (adjustment year)	Investment credit realized [1]	Net revenue reduction			Federal income tax reduction [8]	Other gross revenue effects	Gross revenue reduction over service life flow-through	Refunds by decision and years rates effective	
		Service life flow-through [2]	Annual adjustment [3]	Additional net reduction [4]				Year	Refund [9]
	(A)	(B)	(C)	(D)	(E)	(F)	(D)	(H)	(I)
1973	$22,028	$3,249	$3,249						
(1974)	24,901	3,249	4,805	$1,556	$1,437	$60	$3,053	1974	[9] $1,411
(1975)	62,157	3,249	9,025	5,776	5,332	225	11,333	1975	[9] 13,302
(1976)	65,983	3,249	13,315	10,066	9,291	392	19,749	1976	[9] 245
1974–75	[12] 43,529	[13] 6,915	[12] 6,915						
(1976)	65,983	6,915	13,315	6,400	5,907	275	12,582	1976	[10] 13,611
(1977)	71,965	6,915	17,994	11,079	10,226	476	21,781	1977	[10]22,662
Total refunds through Dec. 31, 1977									51,231
1975–76	[12] 64,070	[12] 11,170	[12] 11,170						
(1977)	71,965	[12] 11,170	[12] 17,994	6,824	6,299	293	13,416	1978	[11] 23,346
(1978)	77,683	11,170	23,045	11,875	10,960	511	23,346		
Year 1978 reduction in excess of service life flow-through									23,346

[1] Exhibit 10–A, table 3, col. (A).
[2] Exhibit 10–A, table 3, col. (D).
[3] Exhibit 10–A, table 3, col. (D) in adjustment year.
[4] Col. (C) minus col. (B). Note duplication of amounts for 1974, 1975, and 1976.
[5] Col. (D) times 0.92307 [(D) times 0.48/1 minus 0.48].
[6] Effects of State income tax and uncollectibles (0.039 times col. (D) for T.Y. 1973 and 0.043 times col. (D) for T.Y. 1974–75 and 1975–76).
[7] Col. (D) plus (E) plus (F).
[8] Col. (G) adjusted as per exhibit 40, computation method 2. Interest added at the rate of 7 percent per year for 1974–77.
[9] D.83162 rates effective Aug. 17, 1974 to Jan. 4, 1976.
[10] D.85287 rates effective Jan. 5, 1976. ½ 1977 included.
[11] A.55492 test year data adjusted to most recent estimates. 1978 reduction, col. (G).
[12] Average of 2 calendar years.
[13] Adjusted as 10/4 times amounts shown in exhibit 10–A, table 3 for 1977 in order to approximately reflect the 10 percent investment credit available under the Tax Reform Act of 1976.

APPENDIX E

TABLE 4.—GENERAL TELEPHONE CO. OF CALIFORNIA INTRASTATE OPERATIONS—COMPUTATION OF REFUNDS AND 1978 REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

[Dollar amounts in thousands]

Test year (adjustment year)	Net revenue reduction						Gross revenue reduction over service life flow-through [7]	Refunds by decision and years rates effective	
	Investment credit realized [1]	Service life flow-through [2]	Annual adjustment [3]	Additional net reduction [4]	Federal income tax reduction [5]	Other gross revenue effects [6]		Year	Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
1970:									
(1971)	$2,802		$200	$200	$185	$33	$418	1971	([9] [12])
(1972)	5,119		420	420	388	69	877	1972	([9] [12])
(1973)	4,477		718	718	663	118	1,499	1973	[9] [12] $1,520
(1974)	5,006		1,052	1,052	971	173	2,196	1974	[9] 2,664
1974	5,006	$1,052	1,052						
(1975)	9,845	1,052	1,706	656	605	131	1,392	1975	[10] 1,632
(1976)	12,267	1,052	2,526	1,474	1,360	294	3,128	1976	[10] 3,428
(1977)	20,093	1,052	3,866	2,814	2,597	561	5,972	1977	[10] 3,267
1976	12,267	2,526	2,526						
(1977)	[12] 20,093	[12] 2,526	[12] 3,866	1,340	1,237	277	2,854		[11] 1,317
Total refunds through Dec. 31, 1977									13,828
(1978)	13,495	2,526	4,766	2,240	2,067	464	4,771	1978	[11] 4,771
Year 1978 reduction in excess of service life flow-through									4,771

[1] Exhibit 2, table 3, col. (A). Note duplication of amounts for 1974 and 1976.
[2] Exhibit 6, table 3, col. (D).
[3] Exhibit 6, table 3, col. (D) in adjustment year.
[4] Col. (C) minus col. (B).
[5] Col. (D) times 0.92307 [(D) times 0.48/1 minus 0.48].
[6] Effects of State income tax and uncollectibles. (0.1645 times col. (D) for T.Y. 1970 and 0.1990 times col. (D) for T.Y. 1974 and 0.20695 times col. (D) for T.Y. 1976).
[7] Col. (D) plus (E) plus (F).
[8] Col. (G) adjusted as per exhibit 25, table 8–A. Interest added at the rate of 7 percent per year for 1971–77.
[9] D. 79367 rates effective Dec. 12, 1971 to Dec. 20, 1974.
[10] O. 83779 rates effective Dec. 21, 1974 to July 17, 1977.
[11] O. 87505 rates effective July 18, 1977. Test year data adjusted to most recent estimates.
[12] Adjusted as 10/4 times amounts shown in exhibit 6, table 3 for 1977 in order to approximately reflect the 10 percent investment credit under the Tax Reform Act of 1976.
[13] Adjustments for revenues not collected are shown on table 7.

APPENOIX F

TABLE 5.—PACIFIC TELEPHONE & TELEGRAPH CO. INTRASTATE OPERATIONS—COMPUTATIONS OF REFUNOS ANO ONGOING REVENUE REOUCTIDN OUE TO IMPUTEO FLOW-THROUGH OF ACCELERATEO TAX OEPRECIATIDN FOR VINTAGE YEAR 1968 ANO 1969 PLANT AOOITIONS

[Dollar amounts in thousands]

Test year	Federal tax effect of accelerated tax depreciation, 1st yr		Additional net revenue reduction vintage year 1968–69 additions [3]	Federal income tax reduction [4]	Other gross revenue effects [5]	Additional gross revenue reduction [6]	Refunds by decision and years rates effective	
	1970 [1]	1968 [2]					Year	Refund
	(A)	(B)	(C)	(O)	(E)	(F)	(G)	(H)
1973	$43,131	$50,132	$7,001	$6,462	$273	$13,736	1974	[8] $6,540
							1975	[8] 17,415
							1976	[8] 203
1974–75	57,103	61,359	4,256	3,929	183	8,368	1976	[8] 9,616
							1977	[8] 9,796
Total refunds through Dec. 31, 1977								43,570
1975–6	65,782	68,599	2,817	2,600	122	5,539	1978	[10] 5,539
Annual ongoing reduction								5,530

[1] Exhibit 32 in A.53587, table II, col. (a), tax depreciation times 48 percent. For fiscal years, use average of calendar years.
[2] Exhibit 32 in A.53587, table II–A, col. (a), tax depreciation times 48 percent. For fiscal years, use average of calendar years.
[3] Col. (B) minus col. (A).
[4] Col. (C) times 0.92307 ((C) times 0.48/1 minus 0.48).
[5] Effects of State income tax and uncollectibles (0.039 times col. (C) for T.Y. 1973 and 0.043 times col. (C) for T.Y. 1974–75 and 1975–76).
[6] (C) plus (D) plus (E).
[7] Col. (I) adjusted as per exhibit 34, p. 4 and exhibit 41. Interest added at the rate of 7 percent per year for 1974–77.
[8] D.83162 rates effective Aug. 17, 1974 to Jan. 4, 1976.
[9] D.85287 rates effective Jan. 5, 1976.
[10] A.55492 test year data adjusted to most recent estimates.
[11] Average of 2 calendar years.

APPENDIX G

TABLE 6.—GENERAL TELEPHONE CO. OF CALIFORNIA INTRASTATE OPERATIONS—COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO IMPUTED FLOW-THROUGH OF ACCELERATED TAX DEPRECIATION FOR VINTAGE YEAR 1969 PLANT ADDITIONS

[Dollar amounts in thousands]

Test year	Federal tax effect of accelerated tax depreciation, 1st yr		Additional net revenue reduction vintage year 1969 additions [2]	Federal income tax reduction [4]	Other gross revenue effects [5]	Additional gross revenue reduction [6]	Refunds by decision and years rates effective	
	1970 [1]	1969 [3]					Year	Refund [7]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
970	$1,811	$3,963	$2,152	$1,986	$353	$4,491		
							1971	([9 11])
							1972	([8 11])
							1973	[8 11] $2,015
							1974	[8] 7,229
1974	11,001	12,055	1,054	973	209	2,236	1974	[9] 81
							1975	[9] 2,819
							1976	[9] 2,843
							1977	[9] 1,502
1976	13,789	14,410	621	573	128	1,322	1977	[10] 670
Total refunds through Dec. 31, 1977								17,159
							1978	[10] 1,311
Annual ongoing reduction								1,311

[1] Exhibit 5–R in A. 53935 and A. 51904 rehearing, table I, col. (a) tax depreciation times 48 percent times intrastate factors of 0.891 for T.Y. 1970, 0.873 for T.Y. 1974, and 0.855 for T.Y. 1976.

[2] Exhibit 5–R, table I–A, col. (e), tax depreciation times 48 percent times intrastate factors as in footnote 1, above.

[3] Col. (B) minus col. (A).

[4] Col. (C) times 0.92307 ((C) times 0.48/minus 0.48).

[5] Effects of State income tax and uncollectibles (0.1645 times col. (C) for T.Y. 1970, 0.1990 times col. (C) for T.Y. 1974, and 0.20695 times col. (C) for T.Y. 1976).

[6] (C) plus (D) plus (E).

[7] Col. (H) adjusted as per exhibit 25, table A–A–2. Interest added at the rate of 7 percent per year for 1971–77.

[8] D. 79367 rates effective Dec. 12, 1971 to Dec. 20, 1974.

[9] O. 83779 rates effective Dec. 21, 1974 to July 17, 1977.

[10] D. 87505 rates effective July 18, 1977. Test year data adjusted to most recent estimates.

[11] Adjustments for revenues not collected are shown on table 7.

APPENDIX H

TABLE 7.—GENERAL TELEPHONE CO. OF CALIFORNIA INTRASTATE OPERATIONS ADJUSTMENTS TO TABLES 2, 4, AND 6 FOR REVENUES NOT COLLECTED

[Dollar amounts in thousands]

Line: No.—Item	Gross revenue reductions		
	Dec. 12 to 31, 1971 (A)	1972 (B)	Jan. 1, to Sept. 22, 1973 (C)
1—Total revenues not collected [1]	$846	$12,601	$4,372
2—Line 1 adjusted to Dec. 31, 1977 refund levels [2]. Refund offset by line 2.	1,313	18,889	5,963
3—Imputed flow-through	377	7,616	5,476
4—Investment tax credit	35	1,299	487
5—Liberalized tax depreciation	291	5,486	
6—Remaining revenues not collected [3]	393	2,994	

[1] Exhibit 2, table 6, line 15 (adjusted for D.83778 refunds).
[2] Adjusted by including interest to match refund amounts.
[3] Line 2, less lines 4, 5, and 6, divided by interest factor.

Commissioner Richard D. Gravelle, Concurring

Commissioner Clarke T. Dedrick, Concurring

We concur.

Todays decision, while attributed to this Commission, is not really ours. We are merely the instrument of delivery. This decision was spawned by the Bell System; nurtured by Congress; brought through adolescence by the efforts of our staff, the cities of San Francisco, Los Angeles, San Diego, and TURN; shaped into maturity by the California Supreme Court; and finally left to us for mere refinement. The entity most responsible for the result of the order as it stands is the Court, which clearly mandated us to achieve a balance between utility and ratepayer which we have finally done. We have also protected eligibility by carefully remaining within the confines of the tax laws and regulations. No one, however, should be confused on the latter point. The ultimate verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be.

SAN FRANCISCO, CALIF., *September 13, 1977.*

RICHARD D. GRAVELLE, *Commissioner.*
CLARKE T. DEDRICK, *Commissioner.*

PACIFIC TELEPHONE & TELEGRAPH CO. AND GENERAL TELEPHONE CO. OF CALIFORNIA

Re. accelerated depreciation and investment tax credit.

Commissioner William Symons, Jr., Dissenting

California stands to lose at least a billion dollars, with nothing to gain, as the Public Utilities Commission majority again plays brinkmanship with the United States Government. There is no need to recklessly risk eligibility for such enormous sums in federal tax deferrals and federal tax forgiveness.

Congress enacted the federal tax laws, and in order to qualify for specific federal tax benefits, it is realistic to expect that the intentions of Congress be expected. Eligibility under the federal tax laws makes it possible for the communication companies in California to use accelerated depreciation and to receive investment tax credit. To have the federal government forego the collection of these taxes is most beneficial to both the utilities and the ratepayers. To risk these tax benefits so recklessly is bad regulatory administration. Loss of eligibility through 1976 as a consequence of California Public Utilities Commission action means that Pacific Telephone will have to pay taxing authorities in Washington, D.C., retroactive tax bills of $764 million. General Telephone will have to pay $223 million. Loss of eligibility into the future will cost our communication system and ratepayers additional hundreds of millions of dollars in taxes.

I cannot support a decision which fails to take the opportunity to resolve the "eligibility" issue before the Commission decision is finalized and "set in concrete." Assurance on the issue of eligibility is procedurally feasible if we were to follow the recommendation of the Administrative Law Judge in this case. The order as originally drafted deferred any effective date until 180 days. This was done to allow the utilities a reasonable period to obtain a ruling on eligibility from the U.S. Internal Revenue Service. Ratepayer interest would have been protected by adequate accounting, refund, and interest provisions.

But today's majority strikes out that simple safeguard. In doing so they ignore the fact that last year's schemes, which the majority recklessly imposed on the state's largest electric utility and the state's largest gas utility, are in grave danger of causing millions of dollars in unnecessary tax liabilities to fall upon those companies. (See Majority and Minority Opinions: A. 54946, *Southern California Edison Company*, D. 86794, December 21, 1976; rehearing based on adverse tax attorneys opinion, D. 87828, September 7, 1977; and A. 55676, *Southern California Gas Company*, D. 85627, March 30, 1976, together with adverse IRS ruling, dated November 22, 1976; California Supreme Court decision pending, in Case SF 23495.)

In light of these danger signals, it is imprudent of the Commission not to exhaust available consultive procedures and thus safeguard the state against the catastrophic consequences of ineligibility.

Instead, the majority lectures Congress on legislative goals. Acting as a school marm to Congress, the majority tells the national legislature that federal tax credits and deferrals may be used to lower monthly utility bills, but may not be used to stimulate job development or accelerated capital investment. Such homey advice is interesting but what the California ratepayers will have to worry about is the bottom line. What will be and the California utility companies have to pay to Washington, D.C., after the IRS has cut through the verbiage of this decision and applied the law?

San Francisco, Calif., *September 13, 1977.*

William Symons, Jr., *Commissioner.*

Commissioner Vernon L. Sturgeon, Dissenting

The inconsistent and cavalier manner in which the majority treats the key issue of eligibility for accelerated depreciation warrants my strong dissent. The majority recognizes, as it must, that our regulatory treatment of accelerated depreciation and the investment tax credit (ITC) must preserve General's and Pacific's eligibility for these tax saving methods. The majority, in one of its few realistic comments on the question, states that:

"Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision." (Mimeo p. 19)

After recognizing and elaborating upon the importance of eligibility, the majority then, incredibly, moves quickly to jeopardize that eligibility by adopting a regulatory accounting scheme whose compliance with the standards of normalization established by the Internal Revenue Code and Treasury Regulations must be considered a matter of speculation. While the majority states confidently (Finding No. 3) that "This method complies with Treasury Regulation 1.167(l)-(1)(h)(6) and is normalization accounting," they admit (at Mimeo p. 41) that "We have here a case of first impression under the tax laws..."

The Examiner's Proposed Report took a sensible approach to the eligibility question by setting an effective date 180 days after the entry of the order. Had a majority of the Commission had the wisdom to adopt such an approach, Pacific and General would have not only the time but the incentive to seek an expeditious IRS ruling. The majority correctly points that "expeditious" is not an adjective frequently associated with IRS rulings (as it is not with decisions of this Commission). However, even if no such ruling were issued within the 180 days following the entry of the order, what harm would occur? Under the Examiner's approach, the order would simply be final at that time. If a ruling was issued, the Commission would then have the opportunity to modify the order if necessary.

It is doubtful that any of the majority would, in the handling of their own federal income taxes, make a decision involving a risk of substantial tax liability in

which their position rested on a legal position which they knew to be a "case of first impression under the tax laws." Today, however, they have asked Pacific, General and their ratepayers to do just that.

VERNON L. STURGEON, *Commissioner.*

SAN FRANCISCO, CALIF., *September 13, 1977.*

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., June 8, 1978.

Index No.: 0167.23-00.

Taxpayer—Pacific Telephone & Telegraph Co.
State—California.
Commission—California Public Utility Commission.
Parent—American Telephone & Telegraph Co.
Representative—Caplin & Drysdale.
Decision X—87838, September 13, 1977.

MR. ROBERT DALENBERG,
Vice President and General Counsel, Pacific Telephone & Telegraph Co.,
140 New Montgomery Street,
San Francisco, Calif.

DEAR MR. DALENBERG: This replies to your ruling request dated September 29, 1977, as supplemented, the latest being dated May 3, 1978, and filed on your behalf by your representatives concerning your company (taxpayer).

You request a ruling that should Decision No. X of the Commission, dated September 13, 1977, become final, will the taxpayer remain eligible for: 1) accelerated depreciation under section 167(1) of the Internal Revenue Code; 2) depreciation based on Class Lives Asset Depreciation Range (CLADR) system for post-1970 public utility property; 3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and 4) the investment tax credit?

Taxpayer is a state corporation and is a subsidiary of its parent, which has its principal place of business at 195 Broadway, New York, New York 10007. Taxpayer is subject to regulation by the Commission with respect to its intrastate rates and services. It is a member of a group of affiliated corporations which files consolidated Federal income tax returns under section 1501 of the Code.

By letter dated December 22, 1977, you have formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. Based on your request, we are replying to the first three issues in this ruling letter and will reply to the investment tax credit issue at a later date.

Several state utilities, taxpayer not being one of them, elected accelerated depreciation in the 1950's and chose to establish a reserve on their books of account and for ratemaking purposes for the deferred taxes. This was a normalization method of accounting.

In 1960 the Commission determined that the flow-through method of accounting was to be used in setting rates for utilities using accelerated depreciation for tax purposes. Taxpayer did not elect the accelerated method of depreciation, but chose to remain on the straight line method for tax purposes (until 1970) and in computing depreciation expense in its regulated books of account. Thus, taxpayer used a straight line method of depreciation for both its regulated books of account and for tax purposes for its pre-1970 public utility property.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 public utility property. Pursuant to section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations, the taxpayer has normalized, based on straight line depreciation, the difference between the longer book lives (to compute depreciation for book purposes) and the shorter CL system lives (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

Pursuant to the Tax Reform Act of 1969, the taxpayer made a timely election to use accelerated depreciation to compute depreciation expense for determining its Federal income tax, beginning with its 1970 tax return and used the normalization method of accounting. Therefore, taxpayer is using an accelerated method

of depreciation with respect to its post-1969 public utility property. As taxpayer was using the straight line method of depreciation, as provided under section 167(l)(1)(A) of the Code, for tax purposes on August 1, 1969, it was not eligible to use the flow-through method of accounting.

Taxpayer has made a timely election to use the CLADR system for its post-1970 public utility property. Pursuant to section 1.167(a)-11(b)(6)(ii) of the regulations, the taxpayer has normalized the difference between the book lives (to compute depreciation for book purposes) and the lower limit of the appropriate asset guideline range (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

The Commission issned a decision on November 6, 1968, concerning taxpayer, establishing rates by reducing taxpayer's tax expense for the test year 1967 as though it had used accelerated depreciation on its 1967 tax return. By computing accelerated depreciation with flow-through, the Commission gave the ratepayers the benefit of a tax deferral which the taxpayer did not actually realize. With the taxpayer's announced use of accelerated depreciation the Commission issued an interim decision on November 24, 1970, holding that taxpayer's rates would be established to reflect its use of accelerated depreciation and the normalization method of accounting. On June 22, 1971, the Commission granted a rate increase to taxpayer based on the interim decision.

On November 26, 1971, the state Supreme Court annulled the interim decision of November 24, 1970, holding that the Commission had erred in failing to consider lawful alternatives to normalization. The court ruled that imputed accelerated depreciation with flow-through was a lawful alternative but remanded to the Commission for consideration of all alternatives, including normalization and any compromise between normalization and imputed accelerated depreciation with flow-through. The court then annulled the Commission's June 22, 1971 decision and ordered the Commission to reinstate the rates established in the 1968 decision. On July 23, 1974, the Commission isued a decision granting taxpayer a rate increase based on accelerated depreciation with normalization. The Commission adopted normalization to preserve the taxpayer's eligibility for accelerated depreciation.

On December 12, 1975, the court annulled that part of the Commission's 1974 order relating to the treatment of tax expense, resulting from the use of accelerated depreciation, principally because the court disagreed with the Commission's conclusion that it had no regulatory authority to consider alternate methods of treating the accelerated depreciation. The court remanded for further proceeding relating to tax expense.

Following additional hearings, the Commission issued Decision X on September 13, 1977. This decision covers the tax issues in three separate rate cases using test periods for: 1) calendar year 1973; 2) fiscal year 7/1/74-6/30/75 and; 3) fiscal year 7/1/75-6/30/76. The Commission ordered the taxpayer to make refunds and annnal reductions in rates with respect to these cases.

It seems the Commission had the view that full flow-through of the tax deferral resulting from using accelerated depreciation was the proper and best ratemaking method, but could not consider it as the taxpayer was not eligible for this method of accounting, since taxpayer was using straight line depreciation on August 1, 1969.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it wonld be nnfair to reflect the reduced rate twice in the rate of return and, therefore, proposed an "average annual adjustment method." In its presentation of this method, the Commission has attempted to take into account section 1.167(l)-1(h)(6) of the regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes.

Decision No. X states that the theory of the method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjnstment for uncollectibles, amounts to the total gross revenne redncticns.

In setting rates the Commission's method uses the taxpayer's actual reserve for deferred taxes for the years 1973, 1974 and 1975, and estimated plant additions for the succeeding three years of each test year and computed the estimated reserve for deferred taxes for these years. The simple average of the average annual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property for the four year period was deducted from the rate base, that was adjusted for the test year depreciation reserve, but not for the additional estimated depreciation reserve for the succeeding three years. As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this amount from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income was then substituted in the cost of service for the larger test year net operating income figure and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the larger test year tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The Commission believes the taxes set aside in the deferred tax reserve shall never be paid and amounts to a tax savings rather than a tax deferral. The depreciation expense, included in the cost of service, was left undisturbed.

The Commission believes the normalization method of accounting does not approach the only sensible and realistic method of setting rates, that is, using the actual tax expense as the cost of service tax expense. It believes their annual average adjustment adopted in its Decision No. X "is a more equitable and realistic method of normalization than the other proposals and the best available now."

Decision No. X states that the actual Federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it and cites an exhibit submitted by the taxpayer in a rate case. It believes that the Code or regulations thereunder do not discuss the estimating process and believes that this method uses the same time period for estimating the reserve for deferred taxes and the tax expense for establishing cost of service for ratemaking purposes; and that section 1.167(1)-1(h)(6) of the regulations is satisfied and eligibility is maintained for accelerated depreciation, CLADR system and the CL system.

In reviewing the taxpayer's record in the proceedings, it came to the attention of the Commission that for the 1968 and 1969 vintage plant additions no accelerated depreciation was ever reflected in taxpayer's rates. In a previous application of taxpayer, imputed flow-through was proposed for the 1968 and 1969 vintage accounts. Decision No. X adopted this imputed flow-through for these years and used it to determine tax expense in each of the three taxpayer's test year cost of services for ratemaking purposes to compute the reduction in rates and the amount of the refund.

The taxpayer became concerned when the Commission's Decision No. X was issued and therefore requested the present ruling to determine whether the decision would impair its eligibility for accelerated depreciation, use of CLADR system under section 1.167(a)-11 of the regulations and the CL system under section 1.167(a)-12. If the decision becomes final and is inconsistent with the Code and regulations thereunder, taxpayer stated it will have enormous Federal tax obligations for both past and future years. The request for this ruling is the result of the Commission's decision.

The taxpayer states it is following the normalization method of accounting in regard to accelerated depreciation under section 1677(1) of the Code and adhering to the normalization of tax deferrals resulting from the use of shorter lives for tax purposes than are used for regulatory purposes to comply with section 1.167(a)-11(b)(6)(ii) of the regulations for post-1970 public utility property CLADR system and section 1.167(a)-12(a)(4)(iii) for pre-1971 public utility property CL system.

It is the taxpayer's belief that the average annual adjustment method is the same as the method proposed by the Commission's staff several years ago and rejected by the Commission as being inconsistent with section 167(1) of the Code and regulations thereunder. The taxpayer states that the simple average of the reserve for deferred taxes that is excluded from the rate base is greater than

the amount of the reserve for deferred taxes excluded from the test year rate base. Therefore, the exclusion of a larger deferred tax reserve covering a different time period than the time period used in determining tax expense for cost of service purposes is precisely what section 1.167(l)–1(h)(6) of the regulations prohibits.

The taxpayer further states that when a computation is made of net revenue reduction, it has a bearing on tax expense because of the necessary mathematical relationship between after-tax net revenues and Federal income taxes. The taxpayer believes the Commission's computation is not how the tax expense under section 1.167(l)–1(h)(6)(i) of the regulations should be computed, otherwise this section of the regulations would have no meaning as far as the amount of the reserve for deferred taxes to be deducted from the rate base is concerned. The taxpayer believes the tax expense as computed under the average annual adjustment method does not represent actual or a proper estimated tax expense for the test year, any future year, or any average of these years.

The taxpayer is also concerned about the Commission's use of the actual reserve for deferred taxes being used for the calendar years 1973, 1974 and 1975, while using estimated figures for all other cost of service items, including tax expense. The deferred tax reserve figures for each of the test years were substantially higher than the original estimated figures, as more property was placed in service than originally estimated.

Should the Commission amend its decision to eliminate the four-year forward averaging of the reserve for deferred taxes, the taxpayer states the deferred portion of normalized tax expense included in the cost of service for each test year would still be equal to the lower estimated figure, while the deferred portion of the normalized tax expense excluded from the rate base would be equal to the higher actual figure. Therefore, the taxpayer believes the amount credited to the reserve and excluded from the rate base should be based on the deferred portion of the tax expense as stated under sections 1.167(l)–1(h)(1)(i) and (iii) of the regulations. The taxpayer further states that if the larger actual amount of the reserve is excluded from the rate base then the actual tax expense must be included in the cost of service for ratemaking purposes, otherwise the exclusion of the larger actual amount of the reserve for deferred taxes, without the use of the actual tax expense, would be in violation of section 1.167(l)–1(h)(6).

In regard to the question of being eligible for the continued use of accelerated method of depreciation for its post-1969 public utility property when the Commission has ordered imputed flow-through treatment with respect to the taxpayer's 1968 and 1969 vintage accounts, taxpayer states that it computes depreciation allowance for its 1968 and 1969 vintage accounts for both its regulated books of account and tax purposes on the straight line method in accordance with section 167(l)(1)(A) of the Code. Also, the imputed flow-through method of accounting for the 1968 and 1969 vintage accounts does not prevent the use of the accelerated methods of depreciation for its post-1969 public utility property. The taxpayer cites section 1.167(l)–1(d)(2)(ii) of the regulations, and believes that the phrase, "with respect to the property" means the normalization requirements with respect to the property on which accelerated depreciation is claimed. The taxpayer believes the normalization method of accounting need not be followed for all property as a condition to using accelerated depreciation for post-1969 public utility property.

In regard to the question of being eligible to continue the use of the CL system for pre-1971 property, the taxpayer states the Commission's treatment of the 1968 and 1969 vintage accounts relates only to accelerated depreciation and does not reflect any adjustment of the shorter lives for the property under the CL system than are being used in computing tax expense and depreciation expense in the cost of service for ratemaking purposes. The taxpayer therefore believes the Commission's imputed flow-through of accelerated depreciation for the 1968 and 1969 vintage accounts does not impair its eligibility to use the CL system with respect to these vintage accounts.

Section 167(l)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (1) method or: (ii) the applicable 1968 method for such property.

Section 167(l)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 166(1)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(l)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation (other than a subsection (1) method), to compute its Federal income tax liability and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)–11(a)(1) of the regulations provides an optional election of an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970.

Section 1.167(a)–11(b)(6)(ii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62–21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating result in its regulated books of account. The normalization method of accounting shall have the same definition as stated in sections 167(l)(3)(G) of the Code and 1.167(l)–1(h).

Section 1.167(a)–11(b)(6)(iii) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(a)–12(a) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. This applies to assets placed in service before January 1, 1971.

Section 1.167(a)–12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62–21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting shall have the same definition as stated in section 167(l)(3)(G) of the Code and section 1.167(l)–1(b).

Section 1.167(a)–12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(l)–1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (1) method (which includes the straight line method) is not prohibited by section 167(l) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(l)–1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(l)–1(d)(2)(ii) of the regulations provides that under section 167(l)(2) of the Code, in the case of post-1969 public utility property, the term "reasonable allowance" means a subsection (1) method or a method of deprecia-

tion otherwise allowable under section 167 if with respect to the property the taxpayer uses a normalization method of regulated accounting.

Section 1.167(l)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(l)(3)(G) of the Code.

Section 1.167(l)-1(h)(2) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(l)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (1) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public property.

Section 1.167(l)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(l)-1(h)(6)(ii) of the regulations provides that the amonnt of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amonnt at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decreased to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of the period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flowing-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(l) of the Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1, 1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so, unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The question presented whether the taxpayer will remain eligible for: (1) accelerated depreciation under section 167(l) of the Code; (2) depreciation based on the CLADR system for post-1970 public utility property; and (3) depreciation based on CL system for pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(l)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking purposes was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167(i)-1(h)(1)(i) and 1.167(l)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property, exceeds the permissible exclusion from the rate base as allowed under section 1.167(l)-1(h)(6)(i) of the regulations, described in section 1.167(l)-1(h)(6)(ii), and the examples set forth in section 1.167(l)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years 1973, 1974 and 1975 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(l)-1(h)(1)(i), (iii) and 1.167(l)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is absent, the exclusion of the actual reserve will be prohibited by section 1.167(l)-1(h)(6)(i).

The election of the CLADR system under section 1.167(a)-11(b)(6)(ii) of the regulations, pertaining to post-1970 public utility property, and the continued elective use of this system are conditioned upon the taxpayer following the normalization method of accounting as provided under section 167(l)(3)(G) of the Code and section 1.167(l)-1(h)(1)(i). We believe the reserve for deferred taxes that is determined over the test year and the succeeding three year period, and includes the tax deferral as determined under section 1.167(a)-11(b)(6)(iii) that is deducted from the rate base, exceeds the permissible exclusion from the rate base as allowed under section 1.167(l)-1(h)(6).

The election of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system, is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(l)(3)(G) of the Code and section 1.167(l)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period, that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(l)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-11(b)(6)(iii) of the regulations pertaining to the elective use of the CLADR system, and under section 1.167(a)-12(a)(4)(iii) pertaining to the elective use the CL system, will result in the termination of the election of the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

There is a question in regard to the treatment of the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions to determine tax expense for the three test years to establish the cost of service for rate-making purposes and whether such treatment conflicts with taxpayer's eligibility to use accelerated depreciation and the normalization method of accounting with respect to its post-1969 public utility property. The Tax Reform Act of 1969 recognized such a problem existed. To remedy this trend to accelerated depreciation and

flow-through whether imputed, or otherwise, Congress froze the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(l) of the Code. Implementing regulations were published. Regardless of what went on before this date if the public utility used straight line depreciation for its pre-1970 public utility property, it would make a timely election to apply accelerated depreciation to its post-1969 public utility property, provided it uses the normalization method of accounting. The taxpayer in this case made a timely election to apply accelerated depreciation to his post-1969 public utility property in accordance with section 167(l)(2)(B) of the Code and section 1.167(l)-1(d)(2)(ii) of the regulations. The continued use of accelerated depreciation is dependent upon the taxpayer following the normalization method of accounting as to its post-1969 public utility property and is not affected by the Commission's use of imputed flow-through as to pre-1970 vintage plant additions.

There also is a question in regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1968 and 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions. The use of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The Commission's use of imputed flow-through for the 1968 and 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

A schedule submitted by the taxpayer, dated March 7, 1978, showed that its depreciation expense, Federal income tax expense (normalized), average rate base and average reserve for deferred taxes increased, along with the addition of plant facilities over a period of 5 years (1973–1977 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(l) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153, it states that taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) and depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(i)-1(h)(1)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation. Additionally, the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions will not be cause for the taxpayer being ineligible to use an accelerated method of depreciation along with the proper normalization method of accounting as to its post-1969 public utility property. The taxpayer made a timely election to use an accelerated method of depreciation and the election is applicable only to its post-1969 public utility property.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe that it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunc-

tion with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount as permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use th estraight line method of depreciation.

Should the Commission's Decision No. X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on CLADR system property and the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(l)-(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of both the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1968 and 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii) of the regulations.

Very truly yours.

GEOFFREY J. TAYLOR,
Chief, Engineering and Valuation Branch.

Index No. 0046.01-00.

JULY 27, 1978.

Taxpayer—Pacific Telephone & Telegraph Co.
State—California.
Commission—California Public Utility Commission.
Parent—American Telephone & Telegraph Co.
Representative—Caplin & Drysdale.
Decision No. X—87838, September 13, 1977.

DEAR MR. DALENBERG: This letter supplements ours of June 8, 1978, in which we responded to your ruling request dated September 29, 1977, as supplemented, and filed on your behalf by the representative of your company.

You requested a ruling whether your company (the taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(l) of the Internal Revenue Code of 1954; (2) depreciation based on Class Lives Asset Depreciation Range (CLADR) system for post-1970 public utility property; (3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and (4) the investment tax credit should Decision No. X of the Commission become final.

By letter dated December 22, 1977, you formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. The reason for this was that there were final regulations covering section 167(l) of the Code but there were no final regulations for section 46(f). Based on your request, we replied to the first three issues in our ruling letter of June 8, 1978, and are now replying to the investment tax credit issue in this letter.

There are no final regulations covering your investment credit issue under section 46(f) of the Internal Revenue Code of 1954. However, Rev. Proc. 72-3, 1972-1 C.B. 698, sets out the conditions under which consideration will be given to the issuance of rulings in advance of the adoption of final regulations. This procedure provides in part that if an inquiry presents an issue on which the answer seems to be clear from the application of the provisions of the statute to the facts described, a ruling will be issued in accordance with specific procedures. This is considered to be such a ruling.

Finding 3 of the Commission's Decision No. X provides for a method of normalizing the tax deferral resulting from the difference between computing Federal income taxes using straight line depreciation expense used for ratemaking purposes and accelerated depreciation expense used for actual Federal income taxes. Our letter of June 8, 1978, dealt with this finding.

Finding 4 of the Commission's Decision No. X provides that the Commission shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of investment tax credit estimated for the next immediate future calendar year as compared to the last year (or last preceding year), and recomputing Federal income tax expense and gross revenue requirements based on that new estimate for each year between rate cases. The Commission contends that this method complies with the requirements of ratable (service life) flow-through selected by the utility under section 46(f)(2) of the Code.

Finding 5 of the Commission's Decision No. X provides that the methods described in Findings 3 and 4 are an attempt to more accurately reflect on rates the abnormal growth in depreciation and investment credit tax reserves compared to the other components of cost of service used in computing rates.

Finding 6 of the Commission's Decision No. X provides that the methods adopted in Decision No. X, as described in Findings 3 and 4, comply with the mandate of the California Supreme Court as set forth in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680.

Pacific has made a timely election to be governed by section 46(f)(2) of the Code in its accounting treatment of the investment tax credit for ratemaking purposes. Therefore, it is of vital concern to Pacific to know whether the specific ratemaking treatment ordered by Decision No. X is consistent with the requirements of section 46(f)(2) of the Code in order that the investment tax credit not be disallowed should Decision No. X become final.

You have explained that the ratemaking treatment of investment credit contained in the Commission's Decision No. X involve the following steps for each of the test years and subsequent years until the next rate case involving a new test year.

First, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test year. The depreciation expense in cost of service included depreciation on the investment in the property that had generated the credit (without any reduction in the basis of the property by any portion of the credit) and the rate base also included such property investment (unreduced by the credit).

Second, at the beginning of the year following the test year, the credit produced by additional investment in property for that coming year was determined. (In the case of future years, these amounts were estimated.) Cost of service as determined for the test year was then further reduced by a ratable amount of such credit; the net revenue requirement for the year following the test year was reduced dollar-for-dollar by that further reduction in cost of service; and rates were reduced for such following year on the basis of the reduction in gross revenue requirement determined by multiplying the net revenue requirement reduction by a net to gross multiplier.

Third, the process described in the second step was repeated for each succeeding year until the next rate case, which involved a new test year.

As explained further, the significant features of these three steps from the standpoint of section 46(f)(2) of the Code are the differences between the treatment of the credit for the test year in the first step and the treatment of the credit in the second and third steps for years following the test year. In the first step, the only credit that was used to reduce cost of service was a ratable portion of the credit resulting from property investment that had been included (unreduced by the credit) both in rate base and in the basis from which the depreciation expense in cost of service was determined. Therefore, rate base was not reduced within the meaning of section 46(f)(2)(B) by any portion of the allowable credit that was used to reduce cost of service under section 46(f)(2)(A). Also, cost of service was reduced under section 46(f)(2)(A) only by a ratable portion of the credit. Cost of service was not reduced further by reduced depreciation expense since the depreciation basis included the total investment in the property (unreduced by the credit) that generated such credit.

By contrast, in the second and third steps, you have explained that rates were recomputed for each coming year by the lone adjustment resulting from including a ratable portion of the coming year's credit in the reduction of cost of service. Although your net investment and depreciation expense thereon were increasing in each year affected by Decision No. X, no adjustment to rates was made to reflect the net increase in rate base, or the net increase to the basis used to determine depreciation expense, due to the investment in the qualified

property that gave rise to the credit. This net increase in investment was totally excluded in determining rate base and depreciation expense in each year following the test year. Therefore, you contend that there was in effect, a further reduction in rates through a reduction to rate based by reason of the credit and a reduction to depreciation expense (as well as a reduction of tax expense by reason of the credit) in each such year.

Pacific is concerned that the treatment of the credit for the years following the test years in the second and third steps does not conform to the requirements of either subparagraph (A) or subparagraph (B) of section 46(f)(2) of the Code. This concern arises because subparagraph (A) can be interpreted to mean that cost of service has been reduced by more than a ratable portion of the credit if, in addition to the reduction to cost of service by a ratable portion of the credit, depreciation expense has also been reduced because the property investment which produced the credit has not been used to reflect a net increase in the basis used to determine depreciation expense. Additionally, Pacific is concerned because subparagraph (B) can be interpreted to mean that there has been a reduction to rate base by reason of the credit if the qualified property, which generated the credit used to determine the ratable reduction in cost of service under subparagraph (A), is not included in rate base to the extent such property represents a net increase in rate base.

Section 46(f)(2) of the Code provides that if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, section 46(f)(1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property of the taxpayer—

(A) If the taxpayers' cost of service, for ratemaking purposes or in its regulated books of account, is reduced by more than a ratable portion of the credit allowable by section 38, or

(B) If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38.

Section 46(f)(6) of the Code provides that for purposes of determining ratable restorations to rate base under section 46(f)(1) and for purposes of determining ratable portions under section 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Section 12.3(a) of the Temporary Income Tax Regulations provides that a public utility may make one of two elections under section 46(f) of the Code (section 46(f)(1) or (2)) with respect to the method of accounting for the investment credit for public utility property for ratemaking purposes. A public utility with public utility property to which section 167(1)(2)(C) applies has an additional option of a third election, section 46(f)(3). If an election under section 46(f)(1), (2), or (3) is made, it is irrevocable. If no election is made, section 46(f)(1) applies as if the taxpayer had elected to have the provisions of section 46(f)(1) apply.

The language of section 46(f)(2) of the Code demonstrates the integrated nature of the conditions set forth in subparagraphs (A) and (B) that will result in the disallowance of the credit if not avoided. In each subparagraph, the term "credit allowable" is used to describe that which may not be used to reduce cost of service faster than ratably as well as that which may not be used to reduce rate base in any manner. Thus, subparagraph (B), in prohibiting a reduction in rate base "by reason of any portion of the credit allowable," and subparagraph (A), in limiting the reduction in cost of service to not more than "a ratable portion of the credit allowable," indicate that any credit, a ratable portion of which is used to reduce cost of service, must be included in rate base in order that there be no reduction in rate base as is required by subparagraph (B).

Additionally, the following House and Senate Committee Reports clarify that compliance with both subparagraphs (A) and (B) of section 46(f)(2) of the Code is to be determined by reference to "any accounting treatment" that can effect a reduction in cost of service or a reduction in rate base.

The language of the Commitee Reports is as follows:

In determining whether or to what extent a credit reduces cost of service, i.e., has been flowed through to income, reference is to be made to any accounting treatment that can affect cost of service. One usual method of flowing through the investment credit is to reduce the amount of Federal income tax

taken into account. Another method of flowing through the investment credit is to reduce, by the amount of the credit, the depreciable basis of the property on the regulated books of account.

In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect the company's permitted profit on investment. . . . H.R. Rep. No. 92–533, 92nd Cong., 1st Sess., at 26 (1971); S. Rep. No. 92–437, 92nd Cong., 1st Sess., at 39 (1971).

With respect to the reduction in cost of service governed by section 46(f)(2)(A) of the Code, the above Committee Reports note at least two methods by which cost of service can be reduced for ratemaking purposes: (1) the usual method of reducing the Federal income tax element in cost of service, and (2) an alternative method of reducing the depreciation expense element in cost of service by not including the investment credit in depreciable basis. It follows, therefore, that the use of more than one method to reduce cost of service would cause an aggregate reduction that could exceed the "ratable portion of the credit allowable" that is permitted under section 46(f)(2)(A).

Under the facts you have presented and our understanding of the ratemaking treatment of the investment tax credit prescribed in the Commission's Decision No. X for the years subsequent to the test year, there could be, in effect, a reduction in Pacific's cost of service for ratemaking purposes by more than a ratable portion of the credit and a reduction in its rate base by reason of a portion or all of the credit.

For the test year, under Decision No. X, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test year. Such treatment would be consistent with the requirement of section 46(f)(2)(A) of the Code to avoid disallowance of the credit. The rate base included the qualified property investment (unreduced by the credit) that had generated the credit. Also, the depreciation expense in cost of service included depreciation on the qualified property investment (which had generated the credit) without any reduction in the depreciation basis of the property by any portion of the credit. Such treatment would be consistent with the requirement of section 46(f)(2)(B) that the rate base not be reduced by any portion of the credit allowable.

For the annual adjustment of rates after the test year, the application of Decision No. X requires an annual recalculation of the ratable portion of the investment tax credit (for reduction of the cost of service) to reflect anticipated investments in new property. There is no indication that this annual adjustment of rates (to reduce cost of service by a ratable portion of the credit allowable on anticipated new investment) also includes an adjustment to rate base, depreciation expense, or other cost of service factors to reflect the resulting net increase of anticipated new investments over retirements from the rate base and depreciation base.

By not including an adjustment to rate base to reflect the net increase as a result of the anticipated new investments, the rate base will have been effectively reduced by reason of the credit generated by such new investments. Therefore, the failure to adjust the rate base to reflect the net increase as a result of the anticipated new investments would be in violation of section 46(f)(2)(B) of the Code because the rate base would be reduced by reason of the credit generated by the new investments. Further, by using an accounting treatment that does not include an adjustment to depreciation expense to reflect the net increase in the depreciation base from anticipated new investments that generated a credit, the cost of service would be considered to have been further reduced by reason of the credit, in violation of section 46(f)(2)(A) and the intent of Congress expressed in the Committee Reports.

Accordingly, should Decision No. X of the Commission become a final determination pursuant to section 46(f)(4), we believe that its application for the adjustment of rates in years subsequent to the test year would be inconsistent with the requirements of section 46(f)(2) of the Code and would result in Pacific's loss of eligibility for the investment tax credit under section 38.

Yours very truly,

JOHN W. HOLT,
Director, Corporation Tax Division.

ACCELERATED DEPRECIATION
Sections 167 (l) and (m)

[Sec. 167(l)]

(l) REASONABLE ALLOWANCE IN CASE OF PROPERTY OF CERTAIN UTILITIES.—

(1) PRE-1970 PUBLIC UTILITY PROPERTY.—

(A) IN GENERAL.—In the case of any pre-1970 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(i) a subsection (l) method, or

(ii) the applicable 1968 method for such property.

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

(B) FLOW-THROUGH METHOD OF ACCOUNTING IN CERTAIN CASES.—In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—

(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

(2) POST-1969 PUBLIC UTILITY PROPERTY.—In the case of any post-1969 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(A) a subsection (l) method,

(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

(3) DEFINITIONS.—For purposes of this subsection—

(A) PUBLIC UTILITY PROPERTY.—The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

(i) electrical energy, water, or sewage disposal services,

(ii) gas or steam through a local distribution system,

(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U. S. C. 701), or

(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(B) PRE-1970 PUBLIC UTILITY PROPERTY.—The term "pre-1970 public utility property" means property which was public utility property in the hands of any person at any time before January 1, 1970.

(C) POST-1969 PUBLIC UTILITY PROPERTY.—The term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(D) APPLICABLE 1968 METHOD.—The term "applicable 1968 method" means, with respect to any public utility property—

(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

(iii) if neither clause (i) nor (ii) applies, a subsection (l) method.

In the case of any section 1250 property to which subsection (j) applies, the term "applicable 1968 method" means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.

(E) APPLICABLE 1968 METHOD IN CERTAIN CASES.—If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (l) method) with respect to any public utility property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be its applicable 1968 method with respect to such property and public utility property of the same (or similar) kind subsequently placed in service.

(F) SUBSECTION (l) METHOD.—The term "subsection (l) method" means any method determined by the Secretary to result in a reasonable allowance under subsection (a), other

than (i) a declining balance method, (ii) the sum of the years-digits method, or (iii) any other method allowable solely by reason of the application of subsection (b)(4) or (j)(1)(C).

(G) NORMALIZATION METHOD OF ACCOUNTING.—In order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

(H) FLOW-THROUGH METHOD OF ACCOUNTING.—The taxpayer used a "flow-through method of accounting" with respect to any public utility property if it used the same method of depreciation (other than a subsection (f) method) to compute its allowance for depreciation under this section and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

(I) JULY 1969 ACCOUNTING PERIOD.—The term "July 1969 accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its tax expense for purposes of reflecting operating results in its regulated books of account.

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

(4) SPECIAL RULES AS TO FLOW-THROUGH METHOD.—

(A) ELECTION AS TO NEW PROPERTY REPRESENTING GROWTH IN CAPACITY.—If the taxpayer makes an election under this subparagraph before June 29, 1970, in the manner prescribed by the Secretary, in the case of taxable years beginning after December 31, 1970, paragraph (2)(C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A) and does not represent the replacement of existing capacity.

(B) CERTAIN PENDING APPLICATIONS FOR CHANGES IN METHOD.—In applying paragraph (1)(B), the taxpayer shall be deemed to have used a flow-through method of accounting for its July 1969 accounting period with respect to any pre-1970 public utility property for which it filed a timely application for change of accounting method before August 1, 1969, if with respect to public utility property of the same (or similar) kind most recently placed in service, it used a flow-through method of accounting for its July 1969 accounting period.

(5) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

[*](m) CLASS LIVES.—

(1) IN GENERAL.—In the case of a taxpayer who has made an election under this subsection for the taxable year, the term "reasonable allowance"

as used in subsection (a) means (with respect to property which is placed in service during the taxable year and which is included in any class for which a class life has been prescribed) only an allowance based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group. The allowance so prescribed may (under regulations prescribed by the Secretary) permit a variance from any class life by not more than 20 percent (rounded to the nearest half year) of such life.

(2) CERTAIN FIRST-YEAR CONVENTIONS NOT PERMITTED.—No convention with respect to the time at which assets are deemed placed in service shall be permitted under this section which generally would provide greater depreciation allowances during the taxable year in which the assets are placed in service than would be permitted if all assets were placed in service ratably throughout the year and if depreciation allowances were computed without regard to any convention.

(3) MAKING OF ELECTION.—An election under this subsection for any taxable year shall be made at such time, in such manner, and subject to such conditions as may be prescribed by the Secretary by regulations.

INVESTMENT CREDIT
Section 46 (f)

[Sec. 46(f)]

(1) (f) LIMITATION IN CASE OF CERTAIN REGULATED COMPANIES.—

(1) Taxpayers who are subject to the provisions of Code Sec. 46(f) are not covered by Sec. 101(c) of the Revenue Act of 1971 or by Sec. 203(e) of the Revenue Act of 1964. See the amendatory notes following Code Sec. 46(f).—CCH.

(1) GENERAL RULE.—Except as otherwise provided in this subsection, no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection); or

(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, the immediately preceding sentence shall not apply to property described in paragraph (5)(B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5)(B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

(2) SPECIAL RULE FOR RATABLE FLOW-THROUGH.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

(3) SPECIAL RULE FOR IMMEDIATE FLOW-THROUGH IN CERTAIN CASES.—In the case of property to which section 167(l)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraphs (1) and (2) shall not apply to such property.

(4) LIMITATION.—

(A) IN GENERAL.—The requirements of paragraphs (1), (2), and (3) regarding cost of service and rate base adjustments shall not be applied to public utility property of the taxpayer to disallow the credit with respect to such property before the first final determination which is inconsistent with paragraph (1), (2), or (3) (as the case may be) is put into effect with respect to public utility property (to which this subsection applies) of the taxpayer. Thereupon, paragraph (1), (2), or (3) shall apply to disallow the credit with respect to public utility property (to which this subsection applies) placed in service by the taxpayer—

(i) before the date that the first final determination, or a subsequent determination, which is inconsistent with paragraph (1), (2), or (3) (as the case may be) is put into effect, and

(ii) on or after the date that a determination referred to in clause (i) is put into effect and before the date that a subsequent determination thereafter which is consistent with paragraph (1), (2), or (3) (as the case may be) is put into effect.

(B) DETERMINATIONS.—For purposes of this paragraph, a determination is a determination made with respect to public utility property (to which this subsection applies) by a governmental unit, agency, instrumentality, or commission or similar body described in subsection (c)(3)(B) which determines the effect of the credit allowed by section 38 (determined without regard to this subsection)—

(i) on the taxpayer's cost of service or rate base for ratemaking purposes, or

(ii) in the case of a taxpayer which made an election under paragraph (2) or the election described in paragraph (3), on the taxpayer's cost of service for ratemaking purposes or in its regulated books of account or rate base for ratemaking purposes.

(C) SPECIAL RULES.—For purposes of this paragraph—

(i) a determination is final if all rights to appeal or to request a review, a rehearing, or a redetermination, have been exhausted or have lapsed,

(ii) the first final determination is the first final determination made after the date of the enactment of this subsection, and

(iii) a subsequent determination is a determination subsequent to a final determination.

(5) PUBLIC UTILITY PROPERTY.—For purposes of this subsection, the term "public utility property" means—

(A) property which is public utility property within the meaning of subsection (c)(3)(B), and

(B) property used predominantly in the trade or business of the furnishing or sale of (i) steam through a local distribution system or (ii) the transportation of gas or steam by pipeline, if the rates for such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in subsection (c)(3)(B).

(6) RATABLE PORTION.—For purposes of determining ratable restorations to base under paragraph (1) and for purposes of determining ratable portions under paragraph (2)(A), the period of time used in computing depreciation expense for purposes of reflecting uperating results in the taxpayer's regulated books of account shall be used.

(7) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

(8) PROHIBITION OF IMMEDIATE FLOWTHROUGH.—An election made under paragraph (3) shall apply only to the amount of the credit allowable under section 38 with respect to public utility property (within the meaning of subsection (a)(6)(D)) determined as if the Tax Reduction Act of 1975 and the Tax Reform Act of 1976 had not been enacted. Any taxpayer who had timely made an election under paragraph (3) may, at his own option and without regard to any requirement imposed by an agency described in subsection (c)(3)(B), elect within 90 days after the date of the enactment of the Tax Reduction Act of 1975 (in such manner as the Secretary shall prescribe) to have the provisions of paragraph (3) apply with respect to the amount of the credit allowable under section 38 with respect to such property which is in excess of the amount determined under the preceding sentence. If such taxpayer does not make such an election, paragraph (1) or (2) (whichever paragraph is applicable without regard to this paragraph) shall apply to such excess credit, except that if neither paragraph (1) nor (2) is applicable (without regard to this paragraph), paragraph (1) shall apply unless the taxpayer elects (in such manner as the Secretary shall prescribe) within 90 days after the date of the enactment of the Tax Reduction Act of 1975 to have the provisions of paragraph (2) apply. The provisions of this paragraph shall not be applied to disallow such excess credit before the first final determination which is inconsistent with such requirements is made, determined in the same manner as under paragraph (4).

(9) SPECIAL RULE FOR ADDITIONAL CREDIT.—If the taxpayer makes an election under subparagraph (B) of subsection (a)(2), for a taxable year beginning after December 31, 1975, then, notwithstanding the prior paragraphs of this subsection, no credit shall be allowed by section 38 in excess of the amount which would be allowed without regard to the provisions of subparagraph (B) of subsection (a)(2) if—

(A) the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by reason of any portion of such credit which results from the transfer of employer securities or cash to an employee stock ownership plan which meets the requirements of section 301(d) of the Tax Reduction Act of 1975;

(B) the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of such credit which results from a transfer described in subparagraph (A) to such employee stock ownership plan; or

(C) any portion of the amount of such credit which results from a transfer described in subparagraph (A) to such employee stock ownership plan is treated for ratemaking purposes in any way other than as though it had been contributed by the taxpayer's common shareholders.

"THE JOHNSON ACT"

§ 1342. Rate orders of State agencies

The district courts shall not enjoin, suspend or restrain the operation of, or compliance with, any order affecting rates chargeable by a public utility and made by a State administrative agency or a rate-making body of a State political subdivision, where:

(1) Jurisdiction is based solely on diversity of citizenship or repugnance of the order to the Federal Constitution; and,

(2) The order does not interfere with interstate commerce; and,

(3) The order has been made after reasonable notice and hearing; and,

(4) A plain, speedy and efficient remedy may be had in the courts of such State.

June 25, 1948, c. 646, 62 Stat. 932.

DECLARATORY JUDGMENT PROVISIONS

A. Judicial Code.

Section 2201 The Declaratory Judgment Act, with one exception for tax exempt organizations, prohibits the issuance of declaratory judgments with respect to tax controversies.

B. Internal Revenue Code.

1. Section 7428 is the Revenue Code section referenced in Judicial Code Section 2201 which permits organizations to seek a declaratory judgment relating to exempt status in either the U.S. District Court for the District of Columbia, the U.S. Tax Court, or the U.S. Court of Claims.

2. There are three other provisions authorizing declaratory judgments in tax cases. These are in the Internal Revenue Code rather than the Judicial Code since they provide for judicial ~~service~~ review in the U.S. Tax Court.

Section 7476 provides for a declaratory judgment procedure for judicial review of determinations relating to the qualification of certain retirement plans.

Section 7477 provides for a declaratory judgment procedure for judicial review of determinations relating to the transfers of property from the United States under Internal Revenue Code Section 367.

Section 7478 provides for a declaratory judgment procedure for judicial review of determinations relating to governmental obligations.

CHAPTER 151.—DECLARATORY JUDGMENTS

§ 2201. Creation of remedy

In a case of actual controversy within its jurisdiction, except with respect to Federal taxes other than actions brought under section 7428 of the Internal Revenue Code of 1954, any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought. Any such declaration shall have the force and effect of a final judgment or decree and shall be reviewable as such.

As amended Oct. 4, 1976, Pub.L. 94-455, Title XIII, § 1306(b)(8), 90 Stat. 1719.

§ 7428. Declaratory judgments relating to status and classification of organizations under section 501(c)(3), etc.

(a) Creation of remedy.—In a case of actual controversy involving—

(1) a determination by the Secretary—

(A) with respect to the initial qualification or continuing qualification of an organization as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) or as an organization described in section 170(c)(2),

(B) with respect to the initial classification or continuing classification of an organization as a private foundation (as defined in section 509(a)), or

(C) with respect to the initial classification or continuing classification of an organization as a private operating foundation (as defined in section 4942(j)(3)), or

(2) a failure by the Secretary to make a determination with respect to an issue referred to in paragraph (1),

upon the filing of an appropriate pleading, the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia may make a declaration with respect to such initial qualification or continuing qualification or with respect to such initial classification or continuing classification. Any such declaration shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Court of Claims, as the case may be, and shall be reviewable as such.

(b) Limitations.—

(1) Petitioner.—A pleading may be filed under this section only by the organization the qualification or classification of which is at issue.

(2) Exhaustion of administrative remedies.—A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Court of Claims, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service. An organization requesting the determination of an issue referred to in subsection (a)(1) shall be deemed to have exhausted its administrative remedies with respect to a failure by the Secretary to make a determination with respect to such issue at the expiration of 270 days after the date on which the request for such determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

(3) Time for bringing action.—If the Secretary sends by certified or registered mail notice of his determination with respect to an issue referred to in subsection (a)(1) to the organization referred to in paragraph (1), no proceeding may be initiated under this section by such organization unless the pleading is filed before the 91st day after the date of such mailing.

(c) Validation of certain contributions made during pendency of proceedings.—

(1) In general.—If—

(A) the issue referred to in subsection (a)(1) involves the revocation of a determination that the organization is described in section 170(c)(2),

(B) a proceeding under this section is initiated within the time provided by subsection (b)(3), and

(C) either—

(i) a decision of the Tax Court has become final (within the meaning of section 7481), or

(ii) a judgment of the district court of the United States for the District of Columbia has been entered, or

(iii) a judgment of the Court of Claims has been entered,

and such decision or judgment, as the case may be, determines that the organization was not described in section 170(c)(2),

then, notwithstanding such decision or judgment, such organization shall be treated as having been described in section 170(c)(2) for purposes of section 170 for the period beginning on the date on which the notice of the revocation was published and ending on the date on which the court first determined in such proceeding that the organization was not described in section 170(c)(2).

(2) Limitation.—Paragraph (1) shall apply only—

(A) with respect to individuals, and only to the extent that the aggregate of the contributions made by any individual to or for the use of the organization during the period specified in paragraph (1) does not exceed $1,000 (for this purpose treating a husband and wife as one contributor), and

(B) with respect to organizations described in section 170(c)(2) which are exempt from tax under section 501(a) (for this purpose excluding any such organization with respect to which there is pending a proceeding to revoke the determination under section 170(c)(2)).

(3) Exception.—This subsection shall not apply to any individual who was responsible, in whole or in part, for the activities (or failures to act) on the part of the organization which were the basis for the revocation.

§ 7476. Declaratory judgments relating to qualification of certain retirement plans

(a) Creation of remedy.—In a case of actual controversy involving—

(1) a determination by the Secretary with respect to the initial qualification or continuing qualification of a retirement plan under subchapter D of chapter 1, or

(2) a failure by the Secretary to make a determination with respect to—

(A) such initial qualification, or

(B) such continuing qualification if the controversy arises from a plan amendment or plan termination,

upon the filing of an appropriate pleading, the Tax Court may make a declaration with respect to such initial qualification or continuing qualification. Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

(b) Limitations.—

(1) Petitioner.—A pleading may be filed under this section only by a petitioner who is the employer, the plan administrator, an employee who has qualified under regulations prescribed by the Secretary or his delegate as an interested party for purposes of pursuing administrative remedies within the Internal Revenue Service, or the Pension Benefit Guaranty Corporation.

(2) Notice.—For purposes of this section, the filing of a pleading by any petitioner may be held by the Tax Court to be premature, unless the petitioner establishes to the satisfaction of the court that he has complied with the requirements prescribed by regulations of the Secretary with respect to notice to other interested parties of the filing of the request for a determination referred to in subsection (a).

(3) Exhaustion of administrative remedies.—The Tax Court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted administrative remedies available to him within the Internal Revenue Service. A petitioner shall not be deemed to have exhausted his administrative remedies with respect to a failure by the Secretary to make a determination with respect to initial qualification or continuing qualification of a retirement plan before the expiration of 270 days after the request for such determination was made.

(4) Plan put into effect.—No proceeding may be maintained under this section unless the plan (and, in the case of a controversy involving the continuing qualification of the plan because of an amendment to the plan, the amendment) with respect to which a decision of the Tax Court is sought has been put into effect before the filing of the pleading. A plan or amendment shall not be treated as not being in effect merely because under the plan the funds contributed to the plan may be refunded if the plan (or the plan as so amended) is found to be not qualified.

(5) Time for bringing action.—If the Secretary sends by certified or registered mail notice of his determination with respect to the qualification of the plan to the persons referred to in paragraph (1) (or, in the case of employees referred to in paragraph (1), to any individual designated under regulations prescribed by the Secretary as a representative of such employee), no proceeding may be initiated under this section by any person unless the pleading is filed before the ninety-first day after the day after such notice is mailed to such person (or to his designated representative, in the case of an employee).

(c) Commissioners.—The chief judge of the Tax Court may assign proceedings under this section or section 7428 to be heard by the commissioners of the court, and the court may authorize a commissioner to make the decision of the court with respect to such proceeding, subject to such conditions and review as the court may by rule provide.

(d) Retirement plan.—For purposes of this section, the term "retirement plan" means—

(1) a pension, profit-sharing, or stock bonus plan described in section 401(a) or a trust which is part of such a plan,

(2) an annuity plan described in section 403(a), or

(3) a bond purchase plan described in section 405(a).

(e) Cross reference.—

For provisions concerning intervention by Pension Benefit Guaranty Corporation and Secretary of Labor in actions brought under this section and right of Pension Benefit Guaranty Corporation to bring action, see section 3061(c) of subtitle A of title III of the Employee Retirement Income Security Act of 1974.

§ 7477. Declaratory judgments relating to transfers of property from the United States

(a) Creation of remedy.—

(1) In general.—In a case of actual controversy involving—

(A) a determination by the Secretary—

(i) that an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, or

(ii) of the terms and conditions pursuant to which an exchange described in section 367(a)(1) will be determined not to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, or

(B) a failure by the Secretary to make a determination as to whether an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes,

upon the filing of an appropriate pleading, the Tax Court may make the appropriate declaration referred to in paragraph (3). Such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

(2) Scope of declaration.—The declaration referred to in paragraph (1) shall be—

(A) in the case of a determination referred to in subparagraph (A) of paragraph (1), whether or not such determination is reasonable, and, if it is not reasonable, a determination of the issue set forth in subparagraph (A)(ii) of paragraph (1), and

(B) in the case of a failure described in subparagraph (B) of paragraph (1), the determination of the issues set forth in subparagraph (A) of paragraph (1).

(b) Limitations.—

(1) Petitioner.—A pleading may be filed under this section only by a petitioner who is a transferor or transferee of stock, securities, or property transferred in an exchange described in section 367(a)(1).

(2) Exhaustion of administrative remedies.—The Tax Court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted administrative remedies available to him within the Internal Revenue Service. A petitioner shall not be deemed to have exhausted his administrative remedies with respect to a failure by the Secretary to make a determination with respect to whether or not an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes before the expiration of 270 days after the request for such determination was made.

(3) Exchange shall have begun.—No proceeding may be maintained under this section unless the exchange is described in section 367(a)(1) with respect to which a decision of the Tax Court is sought has begun before the filing of the pleading.

(4) Time for bringing action.—If the Secretary sends by certified or registered mail to the petitioners referred to in paragraph (1) notice of his determination with respect to whether or not an exchange described in section 367(a)(1) is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes or with respect to the terms and conditions pursuant to which such an exchange will be determined not to be made in pursuance of such a plan, no proceeding may be initiated under this section by any petitioner unless the pleading is filed before the 91st day after the day after such notice is mailed to such petitioner.

(c) Commissioners.—The chief judge of the Tax Court may assign proceedings under this section to be heard by the commissioners of the court, and the court may authorize a commissioner to make the decision of the court with respect to such proceeding, subject to such conditions and review as the court may by rule provide.

Added Pub.L. 94-455, Title X, § 1042(d)(1), Oct. 4, 1976, 90 Stat. 1637.

"SEC. 7478. DECLARATORY JUDGMENTS RELATING TO STATUS OF CERTAIN GOVERNMENTAL OBLIGATIONS.

"(a) CREATION OF REMEDY.—In a case of actual controversy involving—

"(1) a determination by the Secretary whether prospective obligations are described in section 103(a), or

"(2) a failure by the Secretary to make a determination with respect to any matter referred to in paragraph (1),

upon the filing of an appropriate pleading, the Tax Court may make a declaration whether such prospective obligations are described in section 103(a). Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

"(b) LIMITATIONS.—

"(1) PETITIONER.—A pleading may be filed under this section only by the prospective issuer.

"(2) EXHAUSTION OF ADMINISTRATIVE REMEDIES.—The court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted all available administrative remedies within the Internal Revenue Service. A petitioner shall be deemed to have exhausted its administrative remedies with respect to a failure of the Secretary to make a determination with respect to an issue of obligations at the expiration of 180 days after the date on which the request for such determination was made if the petitioner has taken, in a timely manner, all reasonable steps to secure such determination.

"(3) TIME FOR BRINGING ACTION.—If the Secretary sends by certified or registered mail notice of his determination as described in subsection (a)(1) to the petitioner, no proceeding may be initiated under this section unless the pleading is filed before the 91st day after the date of such mailing."

(b) AUTHORITY OF TAX COURT TO ASSIGN PROCEEDINGS TO COMMISSIONERS.—

(1) IN GENERAL.—Subsection (c) of section 7456 (relating to commissioners of the Tax Court) is amended by adding at the end thereof the following new sentence: "The chief judge may assign proceedings under sections 7428, 7476, 7477, and 7478 to be heard by the commissioners of the court, and the court may authorize a commissioner to make the decision of the court with respect to such proceeding subject to such conditions and review as the court may by rule provide."

(2) TECHNICAL AMENDMENTS.—

(A) Section 7476 is amended by striking out subsection (c) and by redesignating subsections (d) and (e) as subsections (c) and (d), respectively.

(B) Section 7477 is amended by striking out subsection (c).

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Paragraph (1) of section 7482(b) (relating to venue for appeal of decision of Tax Court) is amended—

(A) by striking out "provided in paragraph (2)" in paragraph (1) and inserting in lieu thereof "provided in paragraphs (2) and (3)", and

(B) by adding at the end thereof the following new paragraph:

"(3) DECLARATORY JUDGMENT ACTIONS RELATING TO STATUS OF CERTAIN GOVERNMENTAL OBLIGATIONS.—In the case of any decision of the Tax Court in a proceeding under section 7478, such decision may only be reviewed by the Court of Appeals for the District of Columbia."

(2) The table of sections for part IV of subchapter C of chapter 76 is amended by adding at the end thereof the following new item:

"Sec. 7478. Declaratory judgments relating to status of certain governmental obligations."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to requests for determinations made after December 31, 1978.

Internal Revenue Service
Index Number 0167.23-00

Department of the Treasury
Washington, DC 20224

Mr. Robert Dalenberg
Vice-President & General Counsel
Pacific Telephone & Telegraph Company
140 New Montgomery Street
San Francisco, California 94105

Person to Contact:
A.L. Woodman
Telephone Number:
202-566-3392
Refer Reply to:
T:C:E:A:3
Date:
08 JUN 1978

Taxpayer	- Pacific Telephone & Telegraph Co.
State	- California
Commission	- California Public Utility Commission
Parent	- American Telephone & Telegraph Co.
Representative	- Caplin & Drysdale
Decision X	- 87838, September 13, 1977

Dear Mr. Dalenberg:

This replies to your ruling request dated September 29, 1977, as supplemented, the latest being dated May 3, 1978, and filed on your behalf by your representatives concerning your company (taxpayer).

You request a ruling that should Decision No. X of the Commission, dated September 13, 1977, become final, will the taxpayer remain eligible for: 1) accelerated depreciation under section 167(1) of the Internal Revenue Code; 2) depreciation based on Class Lives Asset Depreciation Range (CLADR) system for post-1970 public utility property; 3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and 4) the investment tax credit?

Taxpayer is a state corporation and is a subsidiary of its parent, which has its principal place of business at 195 Broadway, New York, New York 10007. Taxpayer is subject to regulation by the Commission with respect to its intrastate rates and services. It is a member of a group of affiliated corporations which files consolidated Federal income tax returns under section 1501 of the Code.

By letter dated December 22, 1977, you have formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. Based on your request, we are replying to the first three issues in this ruling letter and will reply to the investment tax credit issue at a later date.

Several state utilities, taxpayer not being one of them, elected accelerated depreciation in the 1950's and chose to establish a reserve on their books of account and for ratemaking purposes for the deferred taxes. This was a normalization method of accounting.

In 1960 the Commission determined that the flow-through method of accounting was to be used in setting rates for utilities using accelerated depreciation for tax purposes. Taxpayer did not elect the accelerated method of depreciation, but chose to remain on the straight line method for tax purposes (until 1970) and in computing depreciation expense in its regulated books of account. Thus, taxpayer used a straight line method of depreciation for both its regulated books of account and for tax purposes for its pre-1970 public utility property.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 public utility property. Pursuant to section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations, the taxpayer has normalized, based on straight line depreciation, the difference between the longer book lives (to compute depreciation for book purposes) and the shorter CL system lives (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

Pursuant to the Tax Reform Act of 1969, the taxpayer made a timely election to use accelerated depreciation to compute depreciation expense for determining its Federal income tax, beginning with its 1970 tax return and used the normalization method of accounting. Therefore, taxpayer

is using an accelerated method of depreciation with respect to its post-1969 public utility property. As taxpayer was using the straight line method of depreciation, as provided under section 167(1)(1)(A) of the Code, for tax purposes on August 1, 1969, it was not eligible to use the flow-through method of accounting.

Taxpayer has made a timely election to use the CLADR system for its post-1970 public utility property. Pursuant to section 1.167(a)-11(b)(6)(ii) of the regulations, the taxpayer has normalized the difference between the book lives (to compute depreciation for book purposes) and the lower limit of the appropriate asset guideline range (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

The Commission issued a decision on November 6, 1968, concerning taxpayer, establishing rates by reducing taxpayer's tax expense for the test year 1967 as though it had used accelerated depreciation on its 1967 tax return. By computing accelerated depreciation with flow-through, the Commission gave the ratepayers the benefit of a tax deferral which the taxpayer did not actually realize. With the taxpayer's announced use of accelerated depreciation the Commission issued an interim decision on November 24, 1970, holding that taxpayer's rates would be established to reflect its use of accelerated depreciation and the normalization method of accounting. On June 22, 1971, the Commission granted a rate increase to taxpayer based on the interim decision.

On November 26, 1971, the state Supreme Court annulled the interim decision of November 24, 1970, holding that the Commission had erred in failing to consider lawful alternatives to normalization. The court ruled that imputed accelerated depreciation with flow-through was a lawful alternative but remanded to the Commission for consideration of all alternatives, including normalization and any compromise between normalization and imputed accelerated depreciation with flow-through. The court then annulled the Commission's June 22, 1971 decision and ordered the Commission to reinstate the rates established in the 1968 decision. On July 23, 1974, the Commission issued a decision granting taxpayer a rate increase based on accelerated depreciation with normalization. The Commission adopted normalization to preserve the taxpayer's eligibility for accelerated depreciation.

On December 12, 1975, the court annulled that part of the Commission's 1974 order relating to the treatment of tax expense, resulting from the use of accelerated depreciation, principally because the court disagreed with the Commission's conclusion that it had no regulatory authority to consider alternate methods of treating the accelerated depreciation. The court remanded for further proceeding relating to tax expense.

Following additional hearings, the Commission issued Decision X on September 13, 1977. This decision covers the tax issues in three separate rate cases using test periods for: 1) calendar year 1973; 2) fiscal year 7/1/74 - 6/30/75 and; 3) fiscal year 7/1/75 - 6/30/76. The Commission ordered the taxpayer to make refunds and annual reductions in rates with respect to these cases.

It seems the Commission had the view that full flow-through of the tax deferral resulting from using accelerated depreciation was the proper and best ratemaking method, but could not consider it as the taxpayer was not eligible for this method of accounting, since taxpayer was using straight line depreciation on August 1, 1969.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed an "average annual adjustment method." In its presentation of this method, the Commission has attempted to take into account section 1.167(l)-1(h)(6) of the regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes.

Decision No. X states that the theory of the method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses the taxpayer's actual reserve for deferred taxes for the years 1973, 1974 and 1975, and estimated plant additions for the succeeding three years of each test year and computed the estimated reserve for deferred taxes for these years. The simple average of the average annual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property for the four year period was deducted from the rate base, that was adjusted for the test year depreciation reserve, but not for the additional estimated depreciation reserve for the succeeding three years. As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this amount from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income was then substituted in the cost of service for the larger test year net operating income figure and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the larger test year tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The Commission believes the taxes set aside in the deferred tax reserve shall never be paid and amounts to a tax savings rather than a tax deferral. The depreciation expense, included in the cost of service, was left undisturbed.

The Commission believes the normalization method of accounting does not approach the only sensible and realistic method of setting rates, that is, using the actual tax expense as the cost of service tax expense. It believes their annual average adjustment adopted in its Decision No. X "is a more equitable and realistic method of normalization than the other proposals and the best available now."

Decision No. X states that the actual Federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it and cites an exhibit submitted by the taxpayer in a rate case. It believes that the Code or regulations thereunder do not discuss the estimating process and believes that this method uses the same time period for estimating the reserve for deferred taxes and the tax expense for establishing cost of service for ratemaking purposes; and that section 1.167 (l)-1(h)(6) of the regulations is satisfied and eligibility is maintained for accelerated depreciation, CLADR system and the CL system.

In reviewing the taxpayer's record in the proceedings, it came to the attention of the Commission that for the 1968 and 1969 vintage plant additions no accelerated depreciation was ever reflected in taxpayer's rates. In a previous application of taxpayer, imputed flow-through was proposed for the 1968 and 1969 vintage accounts. Decision No. X adopted this imputed flow-through for these years and used it to determine tax expense in each of the three taxpayer's test year cost of services for ratemaking purposes to compute the reduction in rates and the amount of the refund.

The taxpayer became concerned when the Commission's Decision No. X was issued and therefore requested the present ruling to determine whether the decision would impair its eligibility for accelerated depreciation, use of CLADR system under section 1.167(a)-11 of the regulations and the CL system under section 1.167(a)-12. If the decision becomes final and is inconsistent with the Code and regulations thereunder, taxpayer stated it will have enormous Federal tax obligations for both past and future years. The request for this ruling is the result of the Commission's decision.

The taxpayer states it is following the normalization method of accounting in regard to accelerated depreciation under section 167(l) of the Code and adhering to the normalization of tax deferrals resulting from the use of shorter lives for tax purposes than are used for regulatory purposes to comply with section 1.167(a)-11(b)(6)(ii) of the regulations for post-1970 public utility property CLADR system and section 1.167(a)-12(a)(4)(iii) for pre-1971 public utility property CL system.

It is the taxpayer's belief that the average annual adjustment method is the same as the method proposed by the Commission's staff several years ago and rejected by the Commission as being inconsistent with section 167(l) of the Code and regulations thereunder. The taxpayer states that the simple average of the reserve for deferred taxes that is excluded from the rate base is greater than the amount of the reserve for deferred taxes excluded from the test year rate base. Therefore, the exclusion of a larger deferred tax reserve covering a different time period than the time period used in determining tax expense for cost of service purposes is precisely what section 1.167(l)-1(h)(6) of the regulations prohibits.

The taxpayer further states that when a computation is made of net revenue reduction, it has a bearing on tax expense because of the necessary mathematical relationship between after-tax net revenues and Federal income taxes. The taxpayer believes the Commission's computation is not how the tax expense under section 1.167(l)-1(h)(6)(i) of the regulations should be computed, otherwise this section of the regulations would have no meaning as far as the amount of the reserve for deferred taxes to be deducted from the rate base is concerned. The taxpayer believes the tax expense as computed under the average annual adjustment method does not represent actual or a proper estimated tax expense for the test year, any future year, or any average of these years.

The taxpayer is also concerned about the Commission's use of the actual reserve for deferred taxes being used for the calendar years 1973, 1974 and 1975, while using estimated figures for all other cost of service items, including tax expense. The deferred tax reserve figures for each of the test years were substantially higher than the original estimated figures, as more property was placed in service than originally estimated.

Should the Commission amend its decision to eliminate the four-year forward averaging of the reserve for deferred taxes, the taxpayer states the deferred portion of normalized tax expense included in the cost of service for each test

year would still be equal to the lower estimated figure, while the deferred portion of the normalized tax expense excluded from the rate base would be equal to the higher actual figure. Therefore, the taxpayer believes the amount credited to the reserve and excluded from the rate base should be based on the deferred portion of the tax expense as stated under sections 1.167(l)-1(h)(l)(i) and (iii) of the regulations. The taxpayer further states that if the larger actual amount of the reserve is excluded from the rate base then the actual tax expense must be included in the cost of service for ratemaking purposes, otherwise the exclusion of the larger actual amount of the reserve for deferred taxes, without the use of the actual tax expense, would be in violation of section 1.167(l)-1(h)(6).

In regard to the question of being eligible for the continued use of accelerated method of depreciation for its post-1969 public utility property when the Commission has ordered imputed flow-through treatment with respect to the taxpayer's 1968 and 1969 vintage accounts, taxpayer states that it computes depreciation allowance for its 1968 and 1969 vintage accounts for both its regulated books of account and tax purposes on the straight line method in accordance with section 167(l)(l)(A) of the Code. Also, the imputed flow-through method of accounting for the 1968 and 1969 vintage accounts does not prevent the use of the accelerated methods of depreciation for its post-1969 public utility property. The taxpayer cites section 1.167(l)-1(d)(2)(ii) of the regulations, and believes that the phrase, "with respect to the property" means the normalization requirements with respect to the property on which accelerated depreciation is claimed. The taxpayer believes the normalization method of accounting need not be followed for all property as a condition to using accelerated depreciation for post-1969 public utility property.

In regard to the question of being eligible to continue the use of the CL system for pre-1971 property, the taxpayer states the Commission's treatment of the 1968 and 1969 vintage accounts relates only to accelerated depreciation and does not reflect any adjustment of the shorter lives for the property under the CL system than are being used in computing tax expense and depreciation expense in the cost

of service for ratemaking purposes. The taxpayer therefore believes the Commission's imputed flow-through of accelerated depreciation for the 1968 and 1969 vintage accounts does not impair its eligibility to use the CL system with respect to these vintage accounts.

Section 167(l)(l)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (l) method or; (ii) the applicable 1968 method for such property.

Section 167(l)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(l)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(l)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (l) method), to compute its Federal income tax liability and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-11(a)(l) of the regulations provides an optional election of an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970.

Section 1.167(a)-11(b)(6)(ii) of the regulations provides that, for purpose of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating result in its regulated books of account. The normalization method of accounting shall have the same definition as stated in sections 167 (l)(3)(G) of the Code and 1.167(l)-1(h).

Section 1.167(a)-11(b)(6)(iii) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(a)-12(a) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. This applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting shall have the same definition as stated in section 167(l)(3)(G) of the Code and section 1.167(l)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(l)-1(a)(l) of the regulations provides that the use of a method of depreciation other than a subsection (l) method (which includes the straight line method) is not prohibited by section 167(l) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(l)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(l)-1(d)(2)(ii) of the regulations provides that under section 167(l)(2) of the Code, in the case of post-1969 public utility property, the term "reasonable allowance" means a subsection (l) method or a method of depreciation otherwise allowable under section section 167 if with respect to the property the taxpayer uses a normalization method of regulated accounting.

Section 1.167(l)-1(h)(l)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(l)(3)(G) of the Code.

Section 1.167(l)-1(h)(2) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(l)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated

accounting period or thereafter (including a taxpayer who uses a subsection (l) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public property.

Section 1.167(l)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(l)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decreased to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of the period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flowing-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(l) of the Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1, 1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so, unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The question presented whether the taxpayer will remain eligible for: (1) accelerated depreciation under section 167(l) of the Code; (2) depreciation based on the CLADR system for post-1970 public utility property; and (3) depreciation based on CL system for pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(l)-1(h)(l)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking purposes was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167(l)-1(h)(l)(i) and 1.167(l)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property, exceeds the permissible exclusion from the rate base as allowed under section 1.167(l)-1(h)(6)(i) of the regulations, described in section 1.167(l)-1(h)(6)(ii), and the examples set forth in section 1.167(l)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years 1973, 1974 and 1975 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the

estimated tax expense is inconsistent with sections 1.167 (l)-1(h)(1)(i), (iii) and 1.167(l)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is absent, the exclusion of the actual reserve will be prohibited by section 1.167(l)-1(h)(6)(i).

The election of the CLADR system under section 1.167(a)-11(b)(6)(ii) of the regulations, pertaining to post-1970 public utility property, and the continued elective use of this system are conditioned upon the taxpayer following the normalization method of accounting as provided under section 167(l)(3)(G) of the Code and section 1.167(l)-1(h)(l)(i). We believe the reserve for deferred taxes that is determined over the test year and the succeeding three year period, and includes the tax deferral as determined under section 1.167 (a)-11(b)(6)(iii) that is deducted from the rate base, exceeds the permissible exclusion from the rate base as allowed under section 1.167(l)-1(h)(6).

The election of the CL system under section 1.167(a)-12 (a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system, is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167 (l)(3)(G) of the Code and section 1.167(l)-1(h)(l)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period, that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(l)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-11(b)(6)(iii) of the regulations pertaining to the elective use of the CLADR system, and under section 1.167(a)-12(a)(4)(iii) pertaining to the elective use the CL system, will result in the termination of the election of the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

There is a question in regard to the treatment of the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions to determine tax expense for the three test years to establish the cost of service for rate-making purposes and whether such treatment conflicts with taxpayer's eligibility to use accelerated depreciation and the normalization method of accounting with respect to its post-1969 public utility property. The Tax Reform Act of 1969 recognized such a problem existed. To remedy this trend to accelerated depreciation and flow-through whether imputed, or otherwise, Congress froze the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(1) of the Code. Implementing regulations were published. Regardless of what went on before this date if the public utility used straight line depreciation for its pre-1970 public utility property, it would make a timely election to apply accelerated depreciation to its post-1969 public utility property, provided it uses the normalization method of accounting. The taxpayer in this case made a timely election to apply accelerated depreciation to his post-1969 public utility property in accordance with section 167(1)(2)(B) of the Code and section 1.167(1)-1(d)(2)(ii) of the regulations. The continued use of accelerated depreciation is dependent upon the taxpayer following the normalization method of accounting as to its post-1969 public utility property and is not affected by the Commission's use of imputed flow-through as to pre-1970 vintage plant additions.

There also is a question in regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1968 and 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions. The use of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The Commission's use of imputed flow-through for the 1968 and 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

A schedule submitted by the taxpayer, dated March 7, 1978, showed that its depreciation expense, Federal income tax expense (normalized), average rate base and average reserve for deferred taxes increased, along with the addition of plant facilities over a period of 5 years (1973-1977 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(l) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153, it states that taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(l)-1(h)(l)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation. Additionally, the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions will not be cause for the taxpayer being ineligible to use an accelerated method of depreciation along with the proper normalization method of accounting as to its post-1969

public utility property. The taxpayer made a timely election to use an accelerated method of depreciation and the election is applicable only to its post-1969 public utility property.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe that it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount as permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision No. X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on CLADR system property and the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(l)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of both the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1968 and 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii) of the regulations.

Very truly yours,

Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

Internal Revenue Service
Index Number: 0046.01-00

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Taxpayer	Pacific Telephone & Telegraph Co.
State	California
Commission	California Public Utility Commission
Parent	American Telephone & Telegraph Co.
Representative	Caplin & Drysdale
Decision No. X.	87838, September 13, 1977

Dear Mr. Dalenberg:

This letter supplements ours of June 8, 1978, in which we responded to your ruling request dated September 29, 1977, as supplemented, and filed on your behalf by the representative of your company.

You requested a ruling whether your company (the taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(1) of the Internal Revenue Code of 1954; (2) depreciation based on Class Lives Asset Depreciation Range (CLADR) system for post-1970 public utility property; (3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and (4) the investment tax credit should Decision No. X of the Commission become final.

By letter dated December 22, 1977, you formally requested that the issues be separated and the first three issues answered first and the investment tax cradit issue responded to at a later date. The reason for this was that there were final regulations covering section 167(1) of the Code but there were no final regulations for section 46(f). Based on your request, we replied to the first three issues in our ruling letter of June 8, 1978, and are now replying to the investment tax credit issue in this letter.

There are no final regulations covering your investment credit issue under section 46(f) of the Internal Revenue Code of 1954. However, Rev. Proc. 72-3, 1972-1 C.B. 698, sets out the conditions under which consideration will be given to the issuance of rulings in advance of the adoption of final regulations. This procedure provides in part that if an inquiry presents an issue on which the answer seems to be clear from the application of the provisions of the statute to the facts described, a ruling will be issued in accordance with specific procedures. This is considered to be such a ruling.

Finding 3 of the Commission's Decision No. X provides for a method of normalizing the tax deferral resulting from the difference between computing Federal income taxes using straight line depreciation expense used for ratemaking purposes and accelerated depreciation expense used for actual Federal income taxes. Our letter of June 8, 1978, dealt with this finding.

Finding 4 of the Commission's Decision No. X provides that the Commission shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of investment tax credit estimated for the next immediate future calendar year as compared to the last year (or last preceding year), and recomputing Federal income tax expense and gross revenue requirements based on that new estimate for each year between rate cases. The Commission contends that this method complies with the requirements of ratable (service life) flow-through selected by the utility under section 46(f)(2) of the Code.

Finding 5 of the Commission's Decision No. X provides that the methods described in Findings 3 and 4 are an attempt to more accurately reflect in rates the abnormal growth in depreciation and investment credit tax reserves compared to the other components of cost of service used in computing rates.

Finding 6 of the Commission's Decision No. X provides that the methods adopted in Decision No. X, as described in Findings 3 and 4, comply with the mandate of the California Supreme Court as set forth in City of Los Angeles v. Public Utilities Commission (1975) 15 C 3d 680.

Pacific has made a timely election to be governed by section 46(f)(2) of the Code in its accounting treatment of the investment tax credit for ratemaking purposes. Therefore, it is of vital concern to Pacific to know whether the specific ratemaking treatment ordered by Decision No. X is consistent with the requirements of section 46(f)(2) of the Code in order that the investment tax credit not be disallowed should Decision No. X become final.

You have explained that the ratemaking treatment of investment credit contained in the Commission's Decision No. X involve the following steps for each of the test years and subsequent years until the next rate case involving a new test year.

First, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test year. The depreciation expense in cost of service included depreciation on the investment in the property that had generated the credit (without any reduction in the basis of the property by any portion of the credit) and the rate base also included such property investment (unreduced by the credit).

Second, at the beginning of the year following the test year, the credit produced by additional investment in property for that coming year was determined. (In the case of future years, these amounts were estimated.) Cost of service as determined for the test year was then further reduced by a ratable amount of such credit; the net revenue requirement for the year following the test year was reduced dollar-for-dollar by that further reduction in cost of service; and rates were reduced for such following year on the basis of the reduction in gross revenue requirement determined by multiplying the net revenue requirement reduction by a net to gross multiplier.

Third, the process described in the second step was repeated for each succeeding year until the next rate case, which involved a new test year.

As explained further, the significant features of these three steps from the standpoint of section 46(f)(2) of the Code are the differences between the treatment of the credit for the test year in the first step and the treatment of the credit in the second and third steps for years following the test year. In the first step, the only credit that was used to reduce cost of service was a ratable portion of the credit resulting from property investment that had been included (unreduced by the credit) both in rate base and in the basis from which the depreciation expense in cost of service was determined. Therefore, rate base was not reduced within the meaning of section 46(f)(2)(B) by any portion of the allowable credit that was used to reduce cost of service under section 46(f)(2)(A). Also, cost of service was reduced under section 46(f)(2)(A) only by a ratable portion of the credit. Cost of service was not reduced further by reduced depreciation expense since the depreciation basis included the total investment in the property (unreduced by the credit) that generated such credit.

By contrast, in the second and third steps, you have explained that rates were recomputed for each coming year by the lone adjustment resulting from including a ratable portion of the coming year's credit in the reduction of cost of service. Although your net investment and depreciation expense thereon were increasing in each year affected by Decision No. X, no adjustment to rates was made to reflect the net increase in rate base, or the net increase to the basis used to determine depreciation expense, due to the investment in the qualified property that gave rise to the credit. This net increase in investment was totally excluded in determining rate base and depreciation expense in each year following the test year. Therefore, you contend that there was, in effect, a further reduction in rates through a reduction to rate base by reason of the credit and a reduction to depreciation expense (as well as a reduction of tax expense by reason of the credit) in each such year.

Pacific is concerned that the treatment of the credit for the years following the test years in the second and third steps does not conform to the requirements of either subparagraph (A) or subparagraph (B) of section 46(f)(2) of the Code. This concern arises because subparagraph (A) can be interpreted to mean that cost of service has been reduced by more than a ratable portion of the credit if, in addition to the reduction to cost of service by a ratable portion of the credit, depreciation expense has also been reduced because the property investment which produced the credit has not been used to reflect a net increase in the basis used to determine depreciation expense. Additionally, Pacific is concerned because subparagraph (B) can be interpreted to mean that there has been a reduction to rate base by reason of the credit if the qualified property, which generated the credit used to determine the ratable reduction in cost of service under subparagraph (A), is not included in rate base to the extent such property represents a net increase in rate base.

Section 46(f)(2) of the Code provides that if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, section 46(f)(1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property of the taxpayer--

(A) --If the taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, is reduced by more than a ratable portion of the credit allowable by section 38, or

(B) --If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38.

Section 46(f)(6) of the Code provides that for purposes of determining ratable restorations to rate base under section 46(f)(1) and for purposes of determining ratable portions under section 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Section 12.3(a) of the Temporary Income Tax Regulations provides that a public utility may make one of two elections under section 46(f) of the Code (section 46 (f)(1) or (2)) with respect to the method of accounting for the investment credit for public utility property for ratemaking purposes. A public utility with public utility property to which section 167(l)(2)(C) applies has an additional option of a third election, section 46(f)(3). If an election under section 46(f)(1), (2), or (3) is made, it is irrevocable. If no election is made, section 46(f)(1) applies as if the taxpayer had elected to have the provisions of section 46(f)(1) apply.

The language of section 46(f)(2) of the Code demonstrates the integrated nature of the conditions set forth in subparagraphs (A) and (B) that will result in the disallowance of the credit if not avoided. In each subparagraph, the term "credit allowable" is used to describe that which may not be used to reduce cost of service faster than ratably as well as that which may not be used to reduce rate base in any manner. Thus, subparagraph (B), in prohibiting a reduction in rate base "by reason of any portion of the credit allowable," and subparagraph (A), in limiting the reduction in cost of service to not more than "a ratable portion of the credit allowable," indicate that any credit, a ratable portion of which is used to reduce cost of service, must be included in rate base in order that there be no reduction in rate base as is required by subparagraph (B).

Additionally, the following House and Senate Committee Reports clarify that compliance with both subparagraphs (A) and (B) of section 46(f)(2) of the Code is to be determined by reference to "any accounting treatment" that can effect a reduction in cost of service or a reduction in rate base.

The language of the Committee Reports is as follows:

> In determining whether or to what extent a credit reduces cost of service, i.e., has been flowed through to income, reference is to be made to any accounting treatment that can affect cost of service. One usual method of flowing through the investment credit is to reduce the amount of Federal income tax taken into account. Another method of flowing through the investment credit is to reduce, by the amount of the credit, the depreciable basis of the property on the regulated books of account.
>
> In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect the company's permitted profit on investment....H.R. Rep. No. 92-533, 92nd Cong., 1st Sess., at 26 (1971); S. Rep. No. 92-437, 92d Cong., 1st Sess., at 39 (1971).

With respect to the reduction in cost of service governed by section 46(f)(2)(A) of the Code, the above Committee Reports note at least two methods by which cost of service can be reduced for ratemaking purposes: (1) the usual method of reducing the Federal income tax element in cost of service, and (2) an alternative method of reducing the depreciation expense element in cost of service by not including the investment credit in depreciable basis. It follows, therefore, that the use of more than one method to reduce cost of service would cause an aggregate reduction that could exceed the "ratable portion of the credit allowable" that is permitted under section 46(f)(2)(A).

Under the facts you have presented and our understanding of the ratemaking treatment of the investment tax credit prescribed in the Commission's Decision No. X for the years subsequent to the test year, there could be, in effect, a reduction in Pacific's cost of service for ratemaking purposes by more than a ratable portion of the credit and a reduction in its rate base by reason of a portion or all of the credit.

For the test year, under Decision No. X, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test year. Such treatment would be consistent with the requirement of section 46(f)(2)(A) of the Code to avoid disallowance of the credit. The rate base included the qualified property investment (unreduced by the credit) that had generated the credit. Also, the depreciation expense in cost of service included depreciation on the qualified property investment (which had generated the credit) without any reduction in the depreciation basis of the property by any portion of the credit. Such treatment would be consistent with the requirement of section 46(f)(2)(B) that the rate base not be reduced by any portion of the credit allowable.

For the annual adjustment of rates after the test year, the application of Decision No. X requires an annual recalculation of the ratable portion of the investment tax credit (for reduction of the cost of service) to reflect anticipated investments in new property. There is no indication that this annual adjustment of rates (to reduce cost of service by a ratable portion of the credit allowable on anticipated new investments) also includes an adjustment to rate base, depreciation expense, or other cost of service factors to reflect the resulting net increase of anticipated new investments over retirements from the rate base and depreciation base.

By not including an adjustment to rate base to reflect the net increase as a result of the anticipated new investments, the rate base will have been effectively reduced by reason of the credit generated by such new investments. Therefore, the failure to adjust the rate base to reflect the net increase as a result of the anticipated new investments would be in violation of section 46(f)(2)(B) of the Code because the rate base would be reduced by reason of the credit generated by the new investments. Further, by using an accounting treatment that does not include an adjustment to depreciation expense to reflect the net increase in the depreciation base from anticipated new investments that generated a credit, the cost of service would be considered to have been further reduced by reason of the credit, in violation of section 46(f)(2)(A) and the intent of Congress expressed in the Committee Reports.

Accordingly, should Decision No. X of the Commission become a final determination pursuant to section 46(f)(4), we believe that its application for the adjustment of rates in years subsequent to the test year would be inconsistent with the requirements of section 46(f)(2) of the Code and would result in Pacific's loss of eligibility for the investment tax credit under section 38.

Yours very truly,

John W Holt

John W. Holt
Director, Corporation Tax
Division

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

REGULATORY OCT 1 2 1977

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	)	Application No. 53587
	)	Application No. 51774
	)	Application No. 55214
	)	Case No. 9503
	)	Case No. 9802
	)	Case No. 9832
And Related Matters.	)	Application No. 51904
	)	Application No. 53935
(Re Tax Reserve Matters)	)	Case No. 9100
	)	Case No. 9504
	)	Case No. 9578

RESPONSE OF COMMISSION STAFF
TO MOTION OF PACIFIC TELEPHONE AND TELEGRAPH COMPANY
AND LETTER OF GENERAL TELEPHONE COMPANY OF CALIFORNIA
SEEKING STAFF PARTICIPATION IN PROCEEDINGS
BEFORE THE INTERNAL REVENUE SERVICE

Pacific by motion filed September 30, 1977, seeks an order requiring Staff participation before the IRS on Pacific's request for a ruling on eligibility. General by letter dated September 30, 1977, invites and encourages such participation.

The Staff must oppose these requests:

1. Pacific's and General's Lack of Good Faith Efforts.

Both Pacific and General are inviting rulings of ineligibility under the treatments adopted by D.87838. This is apparent when one reviews the documents included in their various filings before this Commission. Pacific's request for a ruling states:

"STATEMENT OF POSITION

"Although Pacific obviously desires to retain its eligibility for accelerated depreciation, ADR, the class life system, and the investment credit, it believes that the Decision clearly conflicts with the eligibility requirements for these tax benefits, and it cannot in

good faith seek rulings that the Decision is consistent with those requirements. Nonetheless, it is vitally important to Pacific and its customers that the tax effect of the Decision be established before it is permitted to go into effect." (See page 6, Coplin letter, Ex. A to Pacific's motion of September 30, 1977.)

General's request states:

"In General's view, Decision No. 87838 would for these reasons require more than a permissible deduction of normalization reserve from the rate base and General would not be permitted to use accelerated depreciation." (See page 9, Coplin letter accompanying General's letter of September 30, 1977.)

"In General's view, Decision No. 87838 would thus require a more rapid than ratable reduction in cost of service and an impermissible reduction in rate base and General would not be entitled to an investment tax credit in accordance with its election under section 46(f)(2)." (Id., page 15.)

"Since under Decision No. 87838 imputed flow-through with respect to 1969 vintage plant additions begins in 1970, General will not be entitled to use class lives for such property for any year." (Id., p. 18.)

The Staff cannot join Pacific or General in seeking such a ruling of ineligibility, since it believes that eligibility is not impaired under D.87838.

2. Neither Pacific nor the Bell System has heretofore deemed rulings on these questions of eligibility significant.

(a) When Pacific first switched to accelerated depreciation in 1970, it did not believe that it was necessary to seek a ruling as whether its accounting methods would affect eligibility. (V. 4, Tr. 285-286.)

(b) D.80347, August 8, 1972, set Pacific's new rates on flow-through after the annulment of D.78851. Pacific did not seek an IRS ruling as to eligibility because in Pacific's view this was not a "final determination" under the statutes and regulations. (V. 4, Tr. 296; V. 6, Tr. 463-464; V. 8, Tr. 697-703.)

(c) D.83540, which modified D.83162, held that,

> "The impact of normalization upon risk, and hence upon rate of return, was taken into account in the Commission's deliberations and was one of the factors which caused us to reduce the equity return authorized for Pacific below that authorized for other California utilities of similar capital structure. The impact of normalization on Pacific's risk was not specifically discussed because it was not disputed; all parties, including Pacific, conceded that the authorization of normalization reduces risk below that which would otherwise result. This uncontradicted evidence was taken into account in fixing rate of return." (Sheets 4-5, D.833540.)

It is the position of Pacific and General that a rate of return adjustment can impact eligibility (e.g., see Pacific's Opening Brief in A.53587, pages 24 et seq.). Mr. Nolan, the utilities' tax expert testified with respect to the rate of return treatment, vis-a-vis eligibility: "I have some trouble with it." (V. 3, Tr. 262.) Yet, Pacific did not believe that it was necessary to seek an IRS ruling (V. 4, Tr. 356).

(d) The New England Telephone and Telegraph Company has not sought a ruling either before or after a decision of the Maine Public Utilities Commission imputing flow-through and holding such treatment not inconsistent with Section 167. (New England Telephone and Telegraph Company, June 10, 1977, F.C. #2213, U. #3178, C. #429.)

3. Participation before the IRS at this time will not serve justice.

Pacific and General have elected to wait until this time to seek a ruling, although they have had the examiner's report and recommendation since January of this year. Since D.87838 is at this time subject to administrative and judicial review, it may well be that no ruling would be forthcoming because the Commission decision is not "a final determination" within IRS requirements. This very position has been taken by Pacific in the past. (V. 4, Tr. 296; V. 6, Tr. 463-464; V. 8, Tr. 697-703.) Rulings of the IRS may take up to a year to issue, or not issue at all. (V. 3, Tr. 253.) Thus, a resolution of this matter may be indefinitely delayed by Pacific's and General's tactics. The Staff cannot in good faith condone this by becoming a participant.

4. Pacific refers to past Staff participation before the IRS.

The reference here is to the joinder by California Water Service Company with the Commission, rather than the Staff, for a reversal of an earlier IRS ruling of general application. The Commission sought the ruling and joined the utility as a taxpayer to comply with IRS requirements for eligibility for rulings. Both the Commission and the utility sought the same ruling, not opposite ones, as is the situation herein. (See V. 7, Tr. 620-622, 624-627; V. 11, Tr. 984-986.) Neither Pacific nor General is requesting a joinder, as distinguished from "participation", by the Commission or the Staff to seek the same ruling. Thus, it is not clear under IRS procedures, what status the Commission or Staff would have in any proceeding before the IRS. In any event, the position of the Commission and Staff is clear and it does not appear that participation would be more than cumulative.

If the Commission is to issue any further order in this proceeding, it should consider an order noting Pacific's and General's lack of good faith, the potential cost of such lack of good faith, and providing that, if Pacific and General are successful in obtaining rulings of ineligibility, D.87838 will be modified to impute full flow-through to them.

Respectfully submitted,

/s/ TIMOTHY E. TREACY

Timothy E. Treacy
Staff Counsel

Dated: October 11, 1977

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all known parties of record in this proceeding by mailing by first-class mail a copy thereof properly addressed to each such party.

Dated: San Francisco, California
October 11, 1977

/s/ NIKKI STAMATES

Nikki Stamates